sifma asset management group

MANAGED FUNDS ASSOCIATION

May 29, 2018

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

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
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Re: SIFMA AMG and MFA Comment on Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies (Docket No. R-1604; Docket ID OCC-2018-0002; RIN 7100 AF-03); Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules (Docket No. R-1603; RIN 7100-AF 02)

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association's Asset Management Group ("**SIFMA AMG**") and Managed Funds Association ("**MFA**")[1] appreciate the opportunity to comment on the proposed rule of the Board of Governors of the Federal Reserve System (the "**Board**") and the Office of the Comptroller of the Currency (the "**OCC**," and together with the Board, the "**Agencies**") to revise the enhanced Supplementary Leverage Ratio ("**eSLR**") numerator (the "**eSLR Proposal**"), and the proposed rule of the Board to incorporate a stress buffer into certain point-in-time capital requirements, not including the Supplementary Leverage Ratio ("**SLR**") (the "**Stress Buffer Proposal**").

SIFMA AMG members, on behalf of their clients, and MFA members use futures and cleared swaps, as well as other derivatives, for a range of purposes, including as a means to manage or hedge investment risks, such as changes in interest rates, exchange rates, and commodity prices. We welcome the Agencies' efforts to make the capital framework more risk sensitive for a banking organization that provides derivatives clearing services, including by making the SLR and eSLR less likely to be its binding capital constraint. The current SLR and eSLR significantly overstate a banking organization's exposure arising out of derivatives clearing activity by failing to recognize the exposure-reducing effect of initial margin provided by a client. As a result of this overstatement of exposure, end users have experienced reduced access to, and higher fees for, centrally cleared derivatives. Since the introduction of the SLR and eSLR, banking organizations have found it increasingly difficult to justify allocating capital to the historically low-return activity of clearing derivatives. The SLR and eSLR similarly overstate exposures from other low-risk, low-return services, such as custody deposit-taking and repo, and have had similarly negative effects on end users of those services.

1 *See* Annex A for descriptions of SIFMA AMG and MFA.

While we support certain aspects of the eSLR Proposal and Stress Buffer Proposal that would take steps towards the goal of greater risk sensitivity, we believe the proposals are insufficient to address the negative effects that the SLR and eSLR (and their denominator, "total leverage exposure") have had, and would continue to have, on end users. Under the proposals, the "total leverage exposure" measure would continue to influence banking organizations' capital allocation decisions, and would continue to overstate banking organizations' exposure from derivatives clearing activities and other businesses.

- Part I of this letter describes how the SLR and eSLR denominator, "total leverage exposure," overstates a banking organization's exposure from derivatives clearing, and thereby creates disincentives to clear derivatives that have harmed end users.

- Part II describes why, even if the Agencies finalized the eSLR Proposal and Stress Buffer Proposal in their proposed form, the "total leverage exposure" measure would continue to drive banking organizations to allocate capital away from derivatives clearing and toward riskier, but higher returning business activities.

- Part III sets forth our recommendations for achieving the Agencies' goals of increasing risk sensitivity in the capital framework and reducing disincentives created by the capital framework for banking organizations to provide end users with derivatives clearing services, including recognition of the exposure-reducing effect of initial margin in the "total leverage exposure" measure.

I. The "Total Leverage Exposure" Measure Overstates a Banking Organization's Actual Economic Exposure From Derivatives Clearing, Resulting in Negative Consequences for End Users

A. Margin Requirements and Risk Management Practices Ensure that Banking Organizations that Act as Clearing Members Have Limited Exposure When Clearing Derivatives for End Users

Derivatives clearing for clients is fundamentally a low-exposure and, historically, low-return business for banking organizations. When a clearing member acts as agent for a client's centrally-cleared derivatives transactions, and guarantees the client's performance to a central counterparty ("**CCP**"), the probability and extent to which the clearing member will be required to step in and make a payment to the CCP is substantially mitigated by initial margin and variation margin that the client posts, for the following reasons:

- Applicable laws and regulations and CCP rules require the client to post robust amounts of initial margin at all times. For instance, Commodity Futures Trading Commission ("**CFTC**") regulations require the client to post an amount of initial margin to cover the CCP's exposure, meaning an amount of assets that would cover losses, based on price movements for up to five days, with an established confidence level of 99 percent.[2] As noted in a recent CFTC study, CCP initial margin models typically increase that confidence level to 99.7 percent.[3]

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[2] *See* 17 C.F.R. § 39.13(g)(2)(ii)–(iii).

[3] Michael Roberson, CFTC Division of Clearing and Risk, Cleared and Uncleared Margin Comparison for Interest Rate Swaps (Apr. 2018), *available at*: https://www.cftc.gov/sites/default/files/idc/groups/public/%40economicanalysis/documents/file/dcr_cleared_uncleared_margin.pdf (noting that CCP models measure expected shortfalls at a 99.7 percent confidence level, which goes beyond the regulatory requirement of a 99 percent confidence level).

- Applicable laws and regulations and CCP rules further require initial margin to be held in the form of extremely highly liquid assets and to be segregated from the clearing member's own assets. Because the initial margin is so liquid and is segregated from the clearing member's assets, it is available to offset any loss.

- The clearing member requires the client to post cash variation margin in the amount necessary to settle the entire amount of any deficiency related to the market value of the derivative. The client posts variation margin daily as necessary to reflect the current mark-to-market value of the position.

- The clearing member is only economically exposed to the extent that the client defaults and the amount the client owes is not covered by its initial margin and variation margin, both of which are addressed daily by margin calls (and in some cases, intraday margin calls), and other client assets on which the clearing member may have a lien. Even though the clearing member's guarantee covers the entire amount of the client's default, the liquid, segregated margin available to the clearing member or CCP ensures that the economics are the same as if the clearing member's guarantee covered the amount of the client's default net of margin.

As a result, initial and variation margin plainly reduce the clearing member's economic exposure arising out of its guarantee to the CCP.

Thus, while a clearing member's guarantee to the CCP in cleared transactions has sometimes been mischaracterized as being "unlimited,"[4] a clearing member's guarantee obligation is in fact limited to the value of any move in market prices until the position is liquidated following a client's default, less the value of initial margin posted by the client. This is so because the client posts cash variation margin daily to provide a pre-settlement payment in order to reflect the clearing member's current exposure at mark-to-market prices. The clearing member's only remaining exposure arises from any market movement until the next posting of margin or liquidation following the client's default – but again, less the value of segregated initial margin posted by the client, which reduces this potential future exposure.

In addition, the clearing member's guarantee is subject to real-time risk management, which effectively further limits that guarantee in practice. A clearing member's risk management framework sets and monitors credit limits and position limits to control the overall exposure a clearing member has to a particular client. Further, in order to permit the clearing member to quickly remedy a client deficiency (both from an operational and legal perspective), all collateral, including any and all securities entitlements, securities, funds, and other property credited to a client's account, is typically subject to a general lien, continuing first priority security interest, and right of set off and recoupment in favor of the clearing member to secure any deficit or other amounts at any time owed to the clearing member and the CCP. Because of this blanket security interest, a clearing member has all of the rights and remedies available to a secured creditor, which include foreclosure and liquidation of segregated margin to satisfy debts. In sum, from an economic, legal, operational, and practical standpoint, the clearing member's guarantee is limited and subject to multiple layers of risk management measures.

4 *See* FDIC Vice Chairman Thomas M. Hoenig, Post-Crisis Risks and Bank Equity Capital, 18th Annual International Banking Conference at the Federal Reserve Bank of Chicago (Nov. 5, 2015), *available at* https://www.fdic.gov/news/news/speeches/spnov0515.html.

B. The "Total Leverage Exposure" Measure Fails to Recognize the Exposure-Reducing Effect of Initial Margin, Resulting in Negative Effects on End Users

Unfortunately, the "total leverage exposure" measure does not recognize the exposure-reducing effect of initial margin. Rather, a banking organization that clears a derivative for its client as a clearing member is required to calculate its leverage exposure arising out of its guarantee to the CCP as if the client had not posted ***any*** initial margin. Accordingly, the banking organization's ***leverage exposure*** for the transaction significantly exceeds its ***actual economic exposure***. And this result is inconsistent with the SLR's and eSLR's treatment of securities financing transactions, whereby a banking organization acting as agent for a client and providing a guarantee of its client's transaction is permitted to deduct from its leverage exposure the amount of collateral posted by the client.[5] This overstatement of exposure has disincentivized banking organizations from clearing derivatives for clients, which has had real world negative consequences for end users.

Since banking organizations began reporting their "total leverage exposure" measures in 2013, a series of large banking organizations have shut down their U.S. client clearing businesses.[6] We believe the cumulative effect of these market exits has been a substantial reduction in clearing capacity in the market. In addition, a reduction in the number of clearing members has concentrated market power in fewer entities, which has reduced competition and increased systemic risk.

In June 2016, SIFMA AMG conducted a survey of its members to determine the effect of the SLR's and eSLR's failure to recognize the exposure-reducing effect of segregated initial margin on their ability to access clearing services for clients.[7] The survey indicated that SIFMA AMG members have experienced reduced access to cleared derivatives since the introduction of the SLR and eSLR. It also indicated that end users have had to pay higher fees to access cleared derivatives. For instance, 50 percent of respondents were asked to "cap" the notional amount of their interest rate swaps outstanding with a clearing member, 30 percent of interest rate swap users were forced to terminate relationships with a clearing member (and seek clearing services elsewhere, if possible), and 60 percent of survey respondents were asked to pay higher clearing fees for interest rate swaps.

Notably, the survey also showed that SIFMA AMG members experienced higher fees in particular where they posted initial margin in the form of cash. Despite the fact that cash is the safest and most liquid form of margin, SIFMA AMG members' experience has been that some clearing members prefer not to have

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5 *See* U.S. capital rules at § _.10(c)(4)(ii)(F). While this treatment is available where a banking organization's guarantee is limited to the difference between the value of the loaned asset and the value of the collateral, a clearing member's guarantee of a client's derivative trade with a CCP is effectively net of initial margin provided, for the reasons described in Part I above.

6 *See* Deutsche Bank Walks Away From US Swaps Clearing, Financial Times (Feb. 9, 2017), *available at* https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655; State Street Exiting Swaps Clearing Business, Citing New Rules, Bloomberg (Dec. 4, 2014), *available at* https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-business-citing-new-rules; RBS to Wind Down Swaps Clearing Units, Reuters (May 19, 2014), *available at* http://uk.reuters.com/article/uk-rbs-primeservices-divestiture-idUKKBN0DY0PU20140519; BNY Mellon Closes U.S. Derivatives Clearing Business, Pension & Investments (Dec. 20, 2013), *available at* http://www.pionline.com/article/20131210/ONLINE/131219993/bny-mellon-closes-us-derivatives-clearing-business.

7 Twelve SIFMA AMG members responded to the survey, representing an aggregate of over $1 trillion in assets under management. *See* SIFMA AMG Letter to Basel Committee on Banking Supervision (June 30, 2016), *available at* https://www.sifma.org/wp-content/uploads/2017/05/sifma-amg-submits-comments-to-the-basel-committee-on-banking-supervision-on-revisions-to-the-basel-iii-leverage-ratio-framework.pdf. We believe that if SIFMA AMG were to conduct this survey again, the results would not change significantly and may even show a greater negative impact of the SLR and eSLR on its members, given that the SLR and eSLR became binding requirements on January 1, 2018.

clients post margin in the form of cash. Clearing members often prefer initial margin to be in the form of securities because under U.S. Generally Accepted Accounting Principles, cash initial margin posted to a clearing member is generally reflected on the clearing member's balance sheet, which adds to the clearing member's "total leverage exposure," whereas securities initial margin stays off the clearing member's balance sheet. And clearing members often prefer that clients that post initial margin in the form of cash do not post more than the minimum amount required by the relevant CCP, because doing so would make the clearing member's leverage-based capital requirement increase. These responses suggest that the SLR's and eSLR's treatment of initial margin distorts clearing members' incentives.

Clearing members' leverage ratio-induced preference for margin in the form of securities can also burden their clients. For instance, constantly buying and selling high quality liquid assets is time consuming, is subject to transaction costs and delays in settlement, and can require the client to buy or sell securities in odd lot sizes. Additionally, securities margin can be subject to haircuts.

The SLR and eSLR have also increased systemic risk by impeding the portability of a failing clearing member's book of cleared derivatives to other clearing members in times of system-wide stress. In a time of system-wide stress, when capital buffers decline, the SLR and eSLR are more likely to serve as a binding capital constraint on banking organizations throughout the market. In these circumstances, a banking organization might be required to raise capital in order to acquire a book of cleared derivatives from a failing clearing member, which would make the banking organization much less willing to step in to acquire the book. The SLR and eSLR would be pro-cyclical, intensifying market stress at exactly the wrong moment.

These effects of the SLR and eSLR are fundamentally inconsistent with the Pittsburgh G20 Commitments to promote central clearing and with Congress's clear policy choice in favor of clearing, as set forth in Title VII of the Dodd-Frank Act.

II. The Overstatement of Exposure Within the "Total Leverage Exposure" Measure Would Continue to Disincentivize Central Clearing and Other Low-Risk, Low-Return Activities if the Agencies Finalized the Proposals in Their Current Form

Given the SLR's and eSLR's significant negative impacts on end users, we support efforts to recalibrate these requirements so they no longer drive banking organizations' behavior away from low-risk, low-return, leverage ratio-disadvantaged activities like derivatives clearing. However, we have serious doubts as to whether the eSLR Proposal and Stress Buffer Proposal will achieve this intended effect. For at least five reasons, we believe the capital framework, and particularly the "total leverage exposure" measure, would continue to disincentivize banking organizations from providing clearing services to end users, and continue to result in higher fees for derivatives clearing.

First, over time, the eSLR Proposal could *increase*, rather than *decrease*, eSLR requirements for certain U.S. global systemically important banks ("**G-SIBs**") compared to their current eSLR requirements. The eSLR Proposal would peg the eSLR numerator to a banking organization's G-SIB surcharge requirement, as calculated under the more stringent of Method 1 or Method 2 of the G-SIB surcharge methodology. Method 2 of the G-SIB surcharge includes fixed coefficients that do not change as the economy and banking sector undergo natural growth, and as a result, Method 2 G-SIB surcharge scores are likely to increase over time. Moreover, the Basel Committee and the Board have proposed changes both to Method 1 and Method 2 that could result in further increases to G-SIB surcharge requirements.[8] Any increase in the G-SIB surcharge

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[8] *See* Basel Committee on Banking Supervision, Global systemically important banks - revised assessment framework, Consultative document (Mar. 2017), *available at* https://www.bis.org/bcbs/publ/d402.htm; Board of Governors of the Federal Reserve System, Notice of Proposed Agency Information Collection Activities; Comment Request, 82 Fed. Reg. 40,154 (Aug. 24, 2017).

requirement of a U.S. G-SIB would, under the eSLR Proposal, increase the institution's eSLR requirement as well.

Second, the Board's and OCC's impact analysis demonstrates that even in the immediate term, the eSLR Proposal may not meaningfully alter the extent to which the eSLR serves as the binding capital constraint to the U.S. G-SIBs. According to the Board and OCC, the eSLR Proposal would reduce the aggregate amount of Tier 1 capital required across the eight U.S. G-SIBs by approximately $400 million, which is just 0.04% of their aggregate Tier 1 capital. This negligible reduction suggests that the eSLR would remain close to the binding constraint for many U.S. G-SIBs. As such, we believe U.S. G-SIBs will continue to look to the eSLR in allocating capital to business lines, and seek to minimize their "total leverage exposure" so that the eSLR does not become their binding capital constraint.

Third, under the eSLR Proposal, the eSLR would continue to use the flawed "total leverage exposure" measure – both in its denominator and, for the first time, its numerator. "Total leverage exposure," the G-SIB surcharge methodology's proxy for the Size indicator, is a significant determinant of a U.S. G-SIB's G-SIB surcharge score, as are other indicators to which derivatives clearing can contribute.[9] As discussed in Part I above, the "total leverage exposure" measure in its current form significantly overstates a banking organization's actual economic exposure from derivatives clearing.

Fourth, while the proposals are expected, in tandem, to make standardized risk-based capital requirements more likely to be a binding capital constraint for a U.S. G-SIB in the immediate term, they also would increase the importance of the G-SIB surcharge by incorporating a stress buffer into standardized risk-based capital requirements and thereby make the G-SIB surcharge effectively a post-stress test minimum requirement. To minimize their overall capital requirements, then, U.S. G-SIBs would still be incentivized to minimize their clearing activity so as to reduce their G-SIB surcharge scores. Additionally, "total leverage exposure" is the denominator of total loss absorbing capacity ("**TLAC**") and long-term debt ("**LTD**") requirements, both of which can raise the cost of funding for banking organizations. The U.S. G-SIBs would similarly be incentivized to minimize their clearing activity to minimize these requirements.

Fifth, with respect to banking organizations that are subject to the SLR but are *not* G-SIBs, the proposals would not reduce the point-in-time, 3 percent SLR requirement. The 3 percent SLR alone has caused some such banking organizations to reduce their clearing activity or even exit the clearing market entirely.[10] It is therefore reasonable to assume that such banking organizations would not increase their clearing capacity or return to the market if the Agencies adopted the proposals in their current form, without changing the measurement of exposure arising out of derivatives clearing activity.

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[9] Derivatives clearing activity can contribute to the Size, Complexity, and Interconnectedness indicators of the G-SIB surcharge. In August 2017, the Board proposed changes to the FR Y-15 reporting instructions that would expand the types of derivatives clearing transaction structures that are captured within the Complexity and Interconnectedness indicators. SIFMA AMG and MFA oppose these proposed changes. *See* SIFMA AMG and MFA Comment on Proposed Changes to G-SIB Surcharge Calculation (Oct. 20, 2017), *available at* https://www.sifma.org/resources/submissions/sifma-amg-comments-on-g-sib-surcharge-calculation/.

[10] Examples of banking organizations subject to the 3 percent SLR requirement in the United States or the 3 percent Basel Leverage Ratio internationally that have stopped clearing derivatives include Deutsche Bank, RBS, and Nomura. *See* Deutsche Bank Walks Away From US Swaps Clearing, Financial Times (Feb. 9, 2017), *available at* https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655; RBS to Wind Down Swaps Clearing Units, Reuters (May 19, 2014), *available at* http://uk.reuters.com/article/uk-rbs-primeservices-divestiture-idUKKBN0DY0PU20140519; and Nomura Exits Swaps Clearing for US and European Customers, Financial Times (May 12, 2015), *available at* https://www.ft.com/content/e1883676-f896-11e4-be00-00144feab7de.

In sum, we believe that the proposals, in their current form, would not be sufficient to remove the disincentives that the SLR, eSLR, and "total leverage exposure" measure have created for a banking organization to clear derivatives for clients.

III. Recommendations for Changes to the Proposals and Capital Framework

We recommend that the Agencies take the following steps to address the issues identified above and to reduce the extent to which the capital framework would disincentivize banking organizations from providing end users with low-risk, low-return services like derivatives clearing at a reasonable cost:

- The Agencies should revise the "total leverage exposure" measure – as used in the SLR denominator, eSLR denominator, Size indicator of the G-SIB surcharge, TLAC denominator, and LTD requirement denominator – so that initial margin provided by a client in a centrally cleared derivatives transaction reduces a banking organization's exposure arising out of its guarantee of the client's obligation to the CCP.

- To reduce costs to end users of other low-risk, low-return financial services, the Agencies should adopt other amendments to the "total leverage exposure" measure that the U.S. Department of the Treasury has recommended. Consistent with the Treasury Department's recommendations, the "total leverage exposure" measure should exclude (1) initial margin for centrally cleared derivatives, so that banking organizations are not disincentivized from accepting initial margin in the form of cash, (2) cash on deposit with central banks, so that banking organizations are not incentivized to raise fees for custodial deposit-taking services, and (3) U.S. Treasury securities, so that banking organizations are not disincentivized from providing repo to end users and so that liquidity in the U.S. Treasuries markets improves.[11]

- The Agencies should also make the changes recommended in the foregoing bullet points to the denominator of the Tier 1 leverage ratio.

- To decrease the extent to which the eSLR disincentivizes U.S. G-SIBs from providing end users with leverage ratio-disadvantaged services, the Agencies should calibrate the final eSLR so that it (1) results in lower capital requirements than those set forth in the eSLR Proposal, and (2) would not increase capital requirements compared to the current eSLR. The Agencies could achieve both goals by, for example, setting the eSLR requirement with reference to an institution's G-SIB surcharge requirement as calculated under Method 1, but not Method 2.

- If the Agencies finalize the Stress Buffer Proposal, they should do so <u>without</u> revising the proposal to add a stress buffer to the SLR.

These steps would more meaningfully address the seriously negative consequences that the current calibration of the SLR, eSLR, and the "total leverage exposure" measure have had on end users and help ensure that end users can access services such as cleared derivatives to manage or hedge their risks.

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[11] *See* U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities: Banks and Credit Unions, at p. 54 (June 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

We appreciate the Agencies' consideration of our concerns. Should you have any questions, please do not hesitate to contact AMG at Tim Cameron at (202) 962-7447 or tcameron@sifma.org or Laura Martin at (212) 313-1176 or lmartin@sifma.org, AMG's counsel at Covington & Burling LLP, Randy Benjenk at (202) 662-5041 or rbenjenk@cov.com, or MFA at Stuart Kaswell or Laura Harper Powell at (202) 730-2600 or at skaswell@managedfunds.org or lharperpowell@managedfunds.org, respectively.

Respectfully submitted,

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Annex A

Descriptions of SIFMA AMG and MFA

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $39 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.