United States House of Representatives

Committee on Agriculture

Subcommittee on Commodity Exchanges, Energy, and Credit

Impact of Capital and Margin Requirements on End Users

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Introduction

Chairman Scott, Ranking Member Scott and members of the Subcommittee, thank you for the opportunity to discuss capital and margin matters impacting the derivatives industry. I am the President and Chief Executive Officer of FIA. FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system and to promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members help reduce systemic risk in global financial markets.

Clearing ensures that parties to a transaction are protected from the failure of a buyer or seller to perform its obligations, thus minimizing the risk of a counterparty default. The clearinghouse is able to take on this role because it is backed by the collective funds of its clearing members who also guarantee the performance of their clients to make good on their transactions. To protect against default, clearinghouses require that all transactions are secured with appropriate margin. Clearing members, acting as agents for their customers, collect this margin and segregate it away from their own funds as required by the Commodity Exchange Act. They have long performed this function for futures customers, who have historically been required to clear their transactions. More recently, under the "Dodd-Frank Act" (Dodd-Frank) in the U.S. and the "European Market Infrastructure Regulation" (EMIR) in Europe, policymakers determined to extend the clearing requirement beyond futures and options to certain over-the-counter swaps, and as such, the role of the clearing member has expanded. Despite this expansion, over the ten-year period between 2004 and 2014, the clearing member community in the U.S. has decreased from 190 firms to 76 firms.

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

At issue is the Basel leverage ratio, a measurement tool used by banking regulators to determine the amount of leverage that should be backed by capital. Unfortunately, the Basel leverage ratio fails to properly recognize that client margin posted to a bank-affiliated clearing member belongs to the customer, and is provided by the customer to offset the bank's exposure to the clearinghouse. It does not belong to the bank. The assumption that this customer margin can be used by the bank without restriction runs counter to the Commodity Exchange Act and Commodity Futures Trading Commission (CFTC) regulations.

The amount of capital under the Basel leverage ratio required to be held for clearing is estimated between $32 Billion and $66 billion. Once more products are subjected to clearing under the new G-20 clearing mandates those estimates increase to a range of $126 billion and $265 billion. End user clients are beginning to feel the impacts of these costs, which are likely to increase over time as Basel capital requirements are fully implemented.

<u>Background - Basel Leverage Ratio</u>

One of the central reforms to bank capital requirements following the financial crisis was the decision by the Basel Committee on Bank Supervision (Basel Committee) to implement a new type of leverage ratio on a global basis. In January 2014, the Basel Committee finalized its leverage ratio standard. Based on this standard, the Basel leverage ratio was implemented in the United States by the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC). While the leverage ratio will technically not become a legally binding requirement on the largest U.S. banks until January 2018, it already is effectively being implemented by the banks as a result of mandatory reporting requirements and market expectations. Other jurisdictions, including the European Union, Japan and Switzerland, are also in the process of implementing leverage ratio standards based on the Basel leverage ratio.

This Basel leverage ratio would require a bank to hold a minimum amount of capital relative to not only its on-balance sheet assets, but also to its off-balance sheet exposures arising from futures, options, and other derivative transactions. The Basel leverage ratio was designed to be "a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements".[1] While FIA supports the goals of stronger capital requirements and recognizes the leverage ratio of the Basel III requirements as an important backstop to keep leverage in check, we also believe the Basel leverage ratio should accurately reflect the actual economic exposures of the banking entity.

As currently measured, we believe the exposure measure under the leverage ratio is artificially inflated to capture more than actual economic exposures with respect to cleared derivatives transactions. In particular, this real and significant overstatement of actual economic exposure arises from the failure of the Basel leverage ratio measure to recognize the exposure-reducing effect of segregated client margin

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

posted to the bank in the limited context of centrally cleared derivatives transactions. The inflated economic exposure results in unwarranted capital costs.

Failure to Recognize Customer Margin

The Basel leverage ratio has failed to properly consider the exposure-reducing effect of customer margin posted to a prudentially-regulated banking entity that is acting as an agent to facilitate derivatives clearing services on behalf of the client. Such customer margin is posted to a bank-affiliated clearing member to ensure that the clearing member's exposure to the clearinghouse is lessened while also allowing the customer access to the cleared derivatives markets' risk management tools. That is, an end user that utilizes the futures market to hedge its business risks is required to clear such a transaction through a clearinghouse, and in order to do so it must post margin through a clearing member for the purpose of offsetting exposure to the clearinghouse. Oftentimes, the clearing member is affiliated with a bank. Furthermore, Congress, and more specifically this Committee, through the Commodity Exchange Act, requires the clearing member to treat margin received from a customer for cleared derivatives transactions as belonging to the customer and segregated from the clearing member's own funds. Yet the Basel leverage ratio does not recognize this margin for its intended purpose—these are customer funds provided specifically to offset the bank-affiliated clearing member's exposure in their obligation to pay the clearinghouse on behalf of the customer. Such customer margin should therefore be considered an offset in determining the bank's exposure.

Unlike making loans or taking deposits, guaranteeing client trades exposes the bank to losses only to the extent that the margin collected is insufficient to cover the clients' obligations. Indeed, to make sure that such margin is always available to absorb losses arising from the customer's transaction, CFTC rules require that it be posted in the form of either cash or extremely safe and liquid securities such as U.S. Treasuries and that such margin be clearly segregated from the bank's own money. These are customer funds provided specifically by the customer to offset the clearing member's exposure arising from its obligation to pay the clearinghouse on behalf of the customer. Such customer margin should therefore be considered as an offset in determining the bank's exposure. That is, the very nature of initial margin posted by a derivatives customer is solely exposure-reducing with respect to the clearing member's cleared derivatives exposure.

Given these longstanding regulatory requirements and the exposure-reducing function of margin, it stands to reason that the Basel leverage ratio should recognize segregated client margin as reducing a clearing member bank's actual economic exposure to a clearinghouse for purpose of measuring exposure. Nevertheless, the Basel leverage ratio does not recognize this plainly exposure-reducing effect when calculating the clearing member's exposure.

Recently the Basel Committee has proposed to refine its leverage ratio's calculation of exposure for derivatives. While the Basel Committee did not propose to include an offset for initial client margin in cleared derivatives transactions, the Committee requested information on whether the Basel leverage ratio's failure to recognize client margin will harm the cleared derivatives market. We plan to submit a comment letter with data showing that the failure to recognize the exposure-reducing effect of initial margin will adversely impact clearing members' business, customers' access to cleared derivatives, competition, and systemic risk. In fact, many of these effects can already be observed in the market.[2]

To be clear, this has nothing to do with trades undertaken by banks on their own account. Our concerns solely relate to trades that banks clear on behalf of their clients.

Negative Consequences

Left unchanged, the Basel leverage ratio will undermine recent financial regulatory reforms by discouraging banks from participating in the clearing business, thereby reducing access to clearing and limiting hedging opportunities for end users. The failure of the Basel leverage ratio to recognize the exposure-reducing effect of segregated margin will substantially and unnecessarily increase the amount of required capital that will need to be allocated to the clearing businesses within these banking institutions. Banks will be less likely to take on new clients for derivatives clearing. Such a significant increase in required capital will also greatly increase costs for end users, including pension funds and businesses across a wide variety of industries that rely on derivatives for risk management purposes, including agricultural businesses and manufacturers. As a result, market participants may be less likely to use cleared derivatives for hedging and other risk management purposes or, as a result of mandatory clearing obligations for some derivatives, some market participants may not be in a position to hedge their underlying risks.

FIA represents bank and non-bank clearing members and I can assure you that this situation is not one that will benefit the non-bank clearing firm. In fact, many non-bank clearing members – those clearing members not subject to Basel III capital requirements – have weighed in to explain their inability to assume the clearing volume currently done through banks due to their own balance sheet constraints. Moreover, these non-bank clearing members are concerned about the broader market impacts that may arise as a result of fewer access points to the cleared derivatives markets. This harms farmers seeking to manage commodity price fluctuations, commercial companies wishing to lock in prices as they distribute their goods, and pension funds using derivatives to enhance workers' retirement benefits. The negative impacts to the real economy are significant.

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

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[2] *See, e.g.*, SIFMA AMG Submits Comments to the Basel Committee on Banking Supervision on Higher Prices and Reduced Access to Clearing Experienced by Asset Managers (Feb. 1, 2016), available at http://www.sifma.org/issues/item.aspx?id=8589958563.

Significantly increased capital costs will also likely result in market exit by some derivatives clearing members that will find the business no longer economically viable in terms of producing a sufficiently high return on equity. The resulting industry consolidation would increase systemic risk by concentrating derivatives clearing activities in fewer clearing member banks and potentially reduce end user access to the risk mitigation benefits of central clearing.

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

Conclusion

While we were disappointed the Basel Committee's consultation did not include a client margin offset, we were encouraged that the Basel Committee identified the issue in its consultation, and is seeking further evidence and data on the impact of the Basel leverage ratio on client clearing and on banks' business models during the consultation period. FIA is working with its members and other trade associations on its response to the Basel Committee's proposed revisions, including obtaining evidence and data on the impact of the standard.

As part of our response to the Basel Committee, we will identify a number of options to recognize the risk-reducing effects of initial margin. These proposals will be consistent with the goals of the Basel Committee in establishing the Basel leverage ratio. We are hopeful the Basel Committee will recognize our concerns. FIA appreciates the Subcommittee's interest in ensuring that banking regulations do not run counter to the well-established benefits for clients of cleared futures or the new G-20 clearing obligations for swaps.