Meeting Between Staff of the Federal Reserve Board and Representatives of the London Stock Exchange Group
February 29, 2024

Participants: Miti Bekele, Mark Buresh, Brian Chernoff, Sarah Dunning, Isabel Echarte, Anna Lee Hewko, Akos Horvath, David Imhoff, Alex Jiron, Jonah Kind, David Lynch, Jennifer McClean, and Michelle Zhu (Federal Reserve Board)

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Summary: Staff of the Federal Reserve Board met with representatives of the London Stock Exchange Group (LSEG) regarding the agencies' Basel III endgame notice of proposed rulemaking and the Board's GSIB surcharge proposal. LSEG representatives discussed LSEG's comment letter on the proposals, with particular emphasis on the impact of the proposals on derivatives clearing activities.

Attachment

July 2023 US Proposals
Basel 3 Endgame and GSIB

February 2024

- Having obtained member and client feedback, and after conducting internal analysis, LSEG has concerns on the proposals' impact on the cleared derivatives market. We continue to advocate that the proposals should NOT have the objective or outcome of increasing the cost of cleared derivatives as this would contradict the G20 financial market reform efforts to promote the use of cleared derivatives which offer reduced systemic risk from standardization and low counterparty risk
- **LSEG's central advocacy focuses on the GSIB surcharge proposal's Complexity indicator because the use of cleared swaps simplifies market structure (and therefore reduces systemic risk) rather than adding to Complexity as this indicator intends to capture**

DICTUM MEUM PACTUM

LSEG

Cleared OTC Derivatives Swaps: Market structure & critical role of US GSIB

- End-users exposed to interest rate risk can hedge via a variety of instruments: (1) futures; (2) **cleared** OTC swaps; or (3) **uncleared** OTC derivatives products. **Cleared** OTC swaps allow end-user clients to hedge their risk in a tailored manner in highly liquid markets supported by CCPs subject to comprehensive regulation.
- Significant portions of end-users are under clearing mandate for OTC swaps since 2014: "Central clearing of [OTC] derivative products reduces systemic risk through multilateral netting, standardisation, and enhanced market transparency in comparison to purely bilateral OTC derivatives" [1].
- Demand for cleared OTC swaps, despite higher initial margin requirements vs. futures reflects the value to end-users of being able to customise payment schedules to underlying loan profiles, mortgage origination, bond issuance etc. and so allowing for more customised risk management of real economy activities.
- CFTC-regulated Futures Commission Merchants (FCMs) enable end-users ("Clients") to access the cleared OTC swaps market by providing intermediation services. Measured by segregated funds, swaps remain a smaller market vs FCM's futures and options franchises, and F&O activity is not included in GSIB capital charges.
- LCH's SwapClear service supports the global swaps markets with strong shares[2] of notional in all currencies including USD (90%+), and end-user demand for swaps drives our overall flow.

Critical Global Role of US GSIBs for LSEG:

- US GSIBs clear for their own account and also clear as a service to their Clients.
- US GSIBs clear the majority of LCH's SwapClear's total Client cleared OTC swaps:
  - 58% of total Client cleared swaps (of which 91% is cleared via FCMs in what is known as the agency/FCM model)
- The FCM model is utilized by international clients, but 59% of the Client clearing supported by US GSIBs is for US Clients
- US GSIB FCMs are already subject to risk-based and leverage based capital requirements for their clearing services to their clients.
- LCH's SwapClear supports 6 US GSIB FCMs and 6 non-US GSIB FCMs.

LCH SwapClear data	Outstanding Notional 2023 YE	
Client Cleared Swaps	$87 tn	*100%*
- of which US GSIBs	$51 tn	*58%*
- of which Agency/FCM model	$46 tn	*91%*
- of which US clients	$27 tn	*59%*
- of which non-US clients	$19 tn	*41%*

CFTC FCM Financial data [3]	Customer Cleared Swap Seg Req.	
All FCMs	$162 bn	*100%*
- US GSIBs	$138 bn	*85%*
- US non-GSIBs	$ 0 bn	*0%*
- Non-US GSIBs	$ 24 bn	*15%*

[1] *R-1814_012524_157260_368536785073_1.pdf (federalreserve.gov)*

[2] 2023 CCP Volumes and Share in IRD | (clarusft.com)

[3] *Financial Data for FCMs | CFTC , December 2023*

LSEG Comment Letter Summary: Use of cleared swaps should be supported

Position:

Proposals should not have the objective or outcome of increasing the cost of cleared derivatives

- Would contradict G20 financial market reform efforts, catalysed by strong in-crisis performance of cleared markets, to promote the use of cleared derivatives which offer reduced systemic risk from standardization and low counterparty risk
- The use of cleared swaps does not add to systemic complexity and its risks are appropriately captured via other indicators

The application of capital requirements based on metrics that are duplicative and/or risk-insensitive would have material negative impact

- Reduce willingness of clearing brokers to offer services
- Increase cost of services
- Reduce clearing for non-mandate products
- Reduce use of hedging
- U.S. GSIBs would face a competitive disadvantage against non-U.S. GSIBs

Recommendations:

<u>GSIB Surcharge Proposal</u>
Agency/FCM client-cleared notional should continue to be excluded from the GSIB complexity indicator

- FCM-cleared swaps are already captured through other more risk-sensitive GSIB indicators
- Similar changes to the Complexity indicator were proposed and rejected by the Federal Reserve in 2018; the same grounds for rejection are true today
- Back-up FCMs would be less likely to accept ported customer positions, thereby undermining customer protection and increasing systemic risk due to stress-scenario firesales

<u>Basel III endgame proposal</u>
Credit Valuation Adjustment (CVA) risk capital calculation should not include client cleared transactions

- There is no CVA recorded on these off-balance sheet transactions, counterparty risk is already captured in other areas
- Would ensure U.S. clearing brokers do not face a disadvantage against non-U.S. clearing brokers who can exclude CVA risk on client-clearing

Operational Risk capital calculation should not include client-clearing related fees

- Ensure that end-user costs are not increased, clearing is not disincentivised and that risk is captured more accurately
- If they are included, they should be reported on a net basis

LSEG supports industry calls for further cost-benefit analysis ahead of any further rule-making.