AFR Americans for Financial Reform

November 22, 2017

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

RE: Proposed Agency Information Collection Activities (FR Y-15; OMB No. 7100-0352)

Dear Ms. Misback:

On behalf of Americans for Financial Reform, we are writing to express our support for proposed changes (the "Proposal") by the Federal Reserve Board of Governors (the "Board") to the FR Y-15 systemic risk reporting form ("FR Y-15") regarding the treatment of cleared over-the-counter ("OTC") derivatives transactions.[1]

On August 24th of this year the Board released a Proposal to revise the FR Y-15 reporting form to make clear that all cleared derivatives transactions, including those in which the bank acted as an agent guaranteeing the client's performance to the derivatives central counterparty (CCP), should be fully included in Schedules B and D of the FR Y-15 reporting form. The effect of this inclusion is to ensure that all derivatives activity by banks that are CCP members is incorporated into the interconnectedness and complexity scores used in determining the G-SIB capital surcharge. According to industry sources and outside analyses, the full inclusion of this activity will increase G-SIB surcharges significantly, possibly requiring major clearing banks to raise over $10 billion in additional capital.[2]

Industry groups have vociferously protested this change and urged the Federal Reserve to withdraw the proposed changes in the G-SIB scoring process.[3] Their objections fall into two broad categories, substantive and procedural. Substantively, they argue that it is inappropriate to fully include agency cleared derivatives activity in determining the interconnectedness and complexity of a systemically important bank. Procedurally, they argue that this Proposal contains too little analysis and discussion and should be re-issued in a more extensive rulemaking.

As discussed further below, we believe industry's substantive objections are self-serving and misguided. Agency clearing services by a CCP member are a perfect example of the type of activities that should be included in systemic risk metrics and should be associated with a higher G-SIB surcharge. The substantive industry objections rely on arguing that the Board should turn its back on its responsibility to ensure the stability of the most systemically significant institutions and instead embrace different goals such as reducing the cost to CCP members of

[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/.
[2] Woodall, Louie, "Banks Prepare for Battle With Fed Over G-SIB Rules", Risk Magazine, November 3, 2017.
[3] Futures Industry Association and International Swaps and Derivatives Association, "Letter To Federal Reserve Board Re Proposed Agency Information Collection Activities", October 11, 2017. http://bit.ly/2A2V3Ak

clearing derivatives. In cases where industry raises real issues, such as the need to transfer derivatives positions during a CCP recovery process, it would be entirely counterproductive to address such issues by reducing ordinary course of business G-SIB surcharges for the largest and most active clearing members.

We have more sympathy with some of the procedural objections to the current form of the proposal, However, these procedural objections do not go to the issue of whether the surcharge increase is called for substantively, which we strongly believe it is, and we do not believe they are sufficient to justify not proceeding with this change.

Below we discuss these issues further and respond to some industry claims as reflected in the October 11th letter on this issue from the Futures Industry Association (FIA) and the International Swaps and Derivatives Association (ISDA), or "FIA/ISDA Letter".[4]

Agency Clearing Activities Should Be Fully Counted in G-SIB Surcharges

When the G-SIB surcharge rule was finalized, then Federal Reserve Chair Janet Yellen clearly stated its purpose:[5]

> "A key purpose of the capital surcharge is to require the firms themselves to bear the costs that their failure would impose on others…In practice, this final rule will confront these firms with a choice: they must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system. Either outcome would enhance financial stability."

Chair Yellen's statement is inherent in the "expected impact" framework used to calculate the G-SIB surcharge, described by the Board as "the harm it [a G-SIB] would cause to the financial system were it to fail multiplied by the probability that it will fail."[6]

Agency clearing of derivatives is a paradigmatic example of an activity which increases the expected impact of the failure of a firm on other financial institutions and on the financial system as a whole. The default of a firm doing large amounts of agency clearing would greatly increase risks to both the firm's customers and to the CCP itself.[7] This is non-controversial and referenced by organizations such as ISDA itself in its own publications on clearing.[8]

[4] Futures Industry Association and International Swaps and Derivatives Association, "Letter To Federal Reserve Board Re Proposed Agency Information Collection Activities", October 11, 2017. http://bit.ly/2A2V3Ak

[5] Federal Reserve Board of Governors, "Federal Reserve Board Approves Final Rule Requiring Largest, Most Important US Bank Holding Companies To Strengthen Their Capital Positions", Press Release, July 20, 2015. http://bit.ly/2AqrFoq

[6] Board of Governors of the Federal Reserve System, Calibrating the G-SIB Surcharge, July 20, 2015. http://bit.ly/2iKlCR0

[7] Ruffini, Ivana, "Central Clearing: Risks and Customer Protections", Economic Perspectives, Federal Reserve Bank of Chicago, Q4 2015. http://bit.ly/2Bi2L7G

[8] Pirrong, Craig, "The Economics of Central Clearing: Theory and Practice", ISDA Discussion Paper Series Number One, May, 2011. http://on.wsj.com/2ArMKyZ

With respect to CCPs, the failure or default of a clearing member would expose the CCP to market risk and to the need to rebalance positions, greatly increasing the CCP's own risk of failure. As the CCP stress test report by the Commodity Futures Trading Commission (CFTC), puts it, "A clearinghouse will incur market risk only if and when a clearing member fails to meet a payment obligation to the clearinghouse. The credit risk that a clearinghouse takes is thus also that of its members….clearing members are essential to the functioning of a clearinghouse".[9] A failure of a major CCP would in turn have enormous implications across the financial system. The recent Treasury report on capital markets stated that "CCPs are critical infrastructures…that continue to pose systemic risks…and are uniquely interconnected with other U.S. financial institutions".[10] This concern was later underlined by NEC chair Gary Cohn in recent public remarks.[11]

With respect to a customer, the failure of a clearing member would expose customers to the direct risk of loss of margin, and to the risk that the clearinghouse would no longer be able to perform on their derivatives positions.[12]

This is precisely the type of externality risk referred to by Chair Yellen and meant to be taken into account in the "expected impact" framework for determining a G-SIB surcharge. These risks operate both through the increased operational complexity created by customer clearing relationships and the responsibilities of membership in a CCP, and through the increased interconnectedness of a firm doing agency clearing to numerous other financial entities, including customers, CCPs, and indirectly to other clearing members of a CCP and customers of those members which may be affected by the default of a major clearing member.[13] It is thus entirely appropriate and indeed necessary to include agency clearing in G-SIB surcharges and to require additional capital for major clearing intermediaries in order to take into account the increased externality risks of their failure.

Industry's Substantive Arguments Against the Proposal Are Misguided

Arguments in the FIA/ISDA letter against the inclusion of agency clearing volume in the determination of G-SIB surcharges are misguided and only serve to distract from the points laid out above.

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[9] Commodity Futures Trading Commission, Supervisory Stress Test of Clearinghouses, A Report By Staff, November, 2016. http://bit.ly/2Aozueg

[10] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunites: Capital Markets, October, 2017. http://bit.ly/2fPPMR3

[11] Smialek, Jeanna, "Gary Cohn Calls Clearinghouses a New Systemic Problem", Bloomberg News, October 15, 2017. https://bloom.bg/2hYM8cD

[12] Ruffini, Ivana, "Central Clearing: Risks and Customer Protections", Economic Perspectives, Federal Reserve Bank of Chicago, Q4 2015. http://bit.ly/2Bi2L7G

[13] Indeed, recent research finds that the interconnectedness of risks of clearing member failure are not properly incorporated into current systemic risk management techniques such as CCP stress tests and bank capital stress tests. See Paddrick, Mark and H. Peyton Young, "How Safe Are Central Counterparties in Derivatives Markets?", Office of Financial Research Working Paper, November 2, 2017. http://bit.ly/2A3BvM7

Encouraging Central Clearing Is Not the Goal of Capital Regulation: One industry argument is that central clearing itself reduces systemic risk and interconnectedness as compared to bilateral derivatives transactions, and that therefore the Board must seek to lower capital charges connected with central clearing in order to encourage greater volume of such clearing. Industry also makes the related argument that the Board must refrain from any capital regulations that would lead derivatives market intermediaries to increase their prices or market participants to reduce their cleared derivatives activity.

This is a misrepresentation of the entire Dodd-Frank regulatory framework and the Board's responsibility under that framework. The Dodd-Frank Act encourages central clearing by mandating central clearing where such clearing is appropriate. This mandate is the strongest possible way to encourage central clearing. Capital, liquidity, and margin regulation is then intended to reflect systemic risks of derivatives transaction responsibilities, including the systemic risks associated with CCP membership and agency clearing.

By requiring participants in derivatives markets to internalize these risks through holding loss absorbency resources such as capital and margin, systemic risk regulation leads to derivatives pricing that properly reflects the risks to the broader economy of derivatives activities. This may in some cases lead to lowering the level of derivatives activities, including cleared derivatives activities. If capital regulation leads market participants to internalize the costs of derivatives risks that were previously assumed to fall on the rest of society through "too big to fail" support by the public safety net, it would be economically appropriate for derivatives activity to decline.

Further, as has frequently been pointed out by many observers including ISDA itself, central clearing does not inevitably reduce systemic risk and interconnectedness, but instead changes the location of that risk and the way it is managed.[14] When CCPs are well managed and clearing members can be relied on not to default, clearing can be expected to reduce systemic risk and interconnectedness. But this depends on, among other things, the solvency and capital position of clearing members, which are impacted by capital regulation.

The question of the proper relationship between total capital charges for bilateral derivatives transactions and cleared derivatives transactions is also frequently raised by industry in efforts to reduce capital charges for cleared derivatives. This ratio is an entirely separate question from whether major participants in the cleared derivatives markets are properly capitalized. Should regulators feel that the ratio between capital charges in bilateral and cleared derivatives markets do not reflect the relative risks of these activities, they can raise capital charges in bilateral markets rather than reducing capital that supports clearing. In addition, given the many regulatory advantages that already exist for cleared derivatives, we are skeptical that the aggregate costs of clearing derivatives are higher than those of bilateral derivatives, and have seen no comprehensive analysis to that effect.

CCP Recovery and Clearing Capital Charges: Industry also argues that capital charges associated with agency clearing will make it more difficult to transfer derivatives positions to

[14] Pirrong, Craig, "The Economics of Central Clearing: Theory and Practice", ISDA Discussion Paper Series Number One, May, 2011. http://on.wsj.com/2ArMKyZ

solvent clearing members in the event of a clearing member default. Such transfers, or "porting", are a key element of the CCP recovery process. Industry argues that solvent clearing members will be more reluctant to accept porting of customer positions if accepting such positions mean that they will have to raise more capital.

This ignores the key point that better capitalization of agency clearing will reduce the likelihood of clearing member default in the first place. Indeed this is a central goal of capital requirements. Better capitalization of agency clearing also means that all clearing members, including those which do not default, will be more solvent and better capitalized in an absolute sense, meaning that they will be better positioned to contribute to the CCP recovery process.

It is true that during the specific time period around the default of a clearing member, regulators may wish to facilitate porting of client positions by temporarily relaxing associated capital requirements, including related G-SIB surcharges. Such a temporary accommodation, which could for example involve giving clearing members that accept new client positions an extended time period to raise additional capital, could address any concerns around porting of client positions during CCP recovery. Regulators could easily pre-plan for such a process by specifying in advance their regulatory policies during the period immediately following a clearing member default.

This kind of temporary accommodation is entirely different than permitting agency clearing activities to be systematically undercapitalized during normal times. Permitting such undercapitalization would increase systemic risk, contribute to the mispricing of derivatives activities, add to the risk of clearing member default, and reduce the total resources available to clearing members during the recovery process.

Industry's Procedural Arguments Should Not Lead the Board to Withdraw the Proposal

The FIA/ISDA letter also raises a broad range of procedural arguments against the Proposal. These include arguments that the public has not been given adequate analysis or explanation of the proposal and that the proposal does not reflect previous iterations of the G-SIB surcharge.

The Board Must Ensure That the G-SIB Surcharge Reflects Systemic Risk: The FIA/ISDA letter points out that the initial G-SIB surcharge set forth by both U.S. and international regulators did not clearly reflect agency clearing activities. It argues that therefore the Board should refrain from including such activities now.

However, the Board is not obligated to ignore risk-related activities simply because such activities were not previously included in the relatively new G-SIB surcharge framework. Such a commitment would mean that the G-SIB surcharge could never be updated to reflect new considerations concerning financial risk. The Board's judgement should be entirely based on the risks of agency clearing activity and whether the amount of such activity is reasonably related to the expected systemic disruption and external costs that would be created by the failure of a financial institution.

The Board is also not required to conform the U.S. G-SIB surcharge to the exact surcharge definition used by international regulators. Basel regulatory standards are explicitly intended as a floor, not a limitation, on regulatory stringency. If the Board feels that stronger standards are necessary to protect the U.S. economy then the Board must put such standards in place. The entire U.S. G-SIB surcharge framework reflects this commitment, as it substantially diverges from the base BIS framework due to the Board's concern that the international framework was inadequate.

Furthermore, in this case the proper regulation of agency clearing activities is of special concern to U.S. regulators, as the agency clearing model is mostly used by U.S. CCPs. CCPs in other countries are more likely to use the "principal" model which involves explicit contractual commitments to both customers and the CCP.[15] Principal-model clearing is already reflected in G-SIB surcharge scoring.

The Board Should Ensure Adequate Public Communication of Significant Changes in the G-SIB Surcharge Calibration: The FIA/ISDA letter also argues that the Board has not adequately explained this G-SIB surcharge change and its implications to the public, and did not provide sufficient notification by making this change through an alteration in reporting forms.

We agree that the Board should clearly communicate to the public all major changes in the G-SIB surcharge calibration. This includes any future changes that act to reduce the G-SIB surcharge or reflect the removal of potentially systemically risky activities from surcharge scoring. We agree with the Board's decision to extend the comment period for this change. We also believe that the Board should have issued a press release in connection with the initial Proposal which made clear to the public that the seemingly technical changes in the FR Y-15 reporting form would have substantial capital implications.

However, we would point out that significant information is already available to the public concerning this change. The Board has filed with OMB the precise edits to the FR Y-15 form that are under consideration, and these edits are available to the public. The Board also provided a brief public justification of these changes. While it would be reasonable to expand upon this justification, we believe it is substantially self-explanatory and directly reflects the underlying "expected impact" framework for the G-SIB surcharge. This framework was extensively analyzed and explained in the White Paper accompanying the final G-SIB surcharge rule.[16]

Thank you for the opportunity to comment on this Proposal. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

Americans for Financial Reform

[15] LCH Clearnet, "Interest Rate Swap Clearing: Client Access to OTC Derivatives Clearing", Presentation at Nordic Capital Markets Conference, November 21, 2011. http://bit.ly/2B7xcfN

[16] Board of Governors of the Federal Reserve System, Calibrating the G-SIB Surcharge, July 20, 2015. http://bit.ly/2iKlCR0