



CENTER FOR CAPITAL MARKETS

C O M P E T I T I V E N E S S

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February 15, 2019

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

Robert E. Feldman
Executive Secretary
Attention: Comments/RIN 3064–AE80
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW
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Submitted electronically

**RE: Standardized Approach for Calculating the Exposure Amount of
Derivatives Contracts (Federal Reserve: Docket No. R-1629; FDIC: RIN 3064-
AE80; OCC: Docket ID OCC-2018-0030)**

Dear Ms. Misback, Mr. Feldman, and to whom it may concern:

The U.S. Chamber of Commerce Center for Capital Markets Competitiveness (“CCMC”) appreciates the opportunity to comment on the proposal from the Board

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of Governors of the Federal Reserve System (“Federal Reserve”), the Federal Deposit Insurance Corporation (“FDIC”), and the Office of the Comptroller of the Currency (“OCC”) (collectively, the “Agencies”) on the new standardized approach for calculating the exposure amount for derivative contracts. The proposed approach, called the standardized approach for counterparty credit risk (“SA-CCR”), would replace the Current Exposure Method (“CEM”), which banks use to calculate counterparty credit risk exposure and risk-weighted assets (“RWA”) on their derivatives transactions, for the purposes of capital requirements. The switch in methodology would have significant implications in the derivatives markets across all asset classes, impacting the capital that banks must hold against these transactions.

There are many benefits to using SA-CCR. For instance, SA-CCR allows for delta-weighting and netting offsets. However, in some cases, SA-CCR, as proposed, would increase costs exponentially for commercial end-users using derivatives to hedge risk. Accordingly, CCMC would encourage the Agencies to:

- Better align the SA-CCR methodology with existing end-user exemptions and default risk mitigation techniques in order to avoid unintended consequences, such as higher hedging costs, reduced liquidity, and reduced accessibility to the markets for end-users;
- Recognize client initial margin for purposes of the SA-CCR methodology within the supplementary leverage ratio framework; and
- Maintain the delta-weighting and offset for netting permitted under SA-CCR.

1) **The Agencies should better align the SA-CCR methodology with existing end-user exemptions and default risk mitigation techniques in order to avoid unintended consequences, such as higher hedging costs, reduced liquidity, and reduced accessibility to the markets for end-users.**

Commercial end-users are typically exempt from margin and clearing requirements, because Congress acknowledged that these counterparties use derivatives primarily to hedge their commercial risk, making these transactions

inherently less risky.¹ Commercial end-users use derivatives to ensure access to commodities, raw materials, and other goods and services at a stable price.

In aiming to improve the risk-sensitivity of the calculation of exposure, SA-CCR assigns significantly higher capital charges to unmargined derivatives transactions, compared to margined transactions. However, the Agencies fail to take into account the benefits of commercial end-users utilizing the derivatives market to hedge business risks. Moreover, while end-users are generally exempt from cash margin requirements, they are subject to other approaches to mitigate default risk. Banks oftentimes require some form of non-cash collateral from end-users, such as liens on assets or letters of credit, to cover their default exposure. However, as proposed, SA-CCR does not recognize these types of non-cash collateral as risk-reducing measures.

Additionally, the proposal would apply an overly conservative supervisory factor across all types of commodity derivatives, rather than recognizing variations in maturities of these contracts and differences in volatility between the underlying commodities. Therefore, end-users are disproportionately affected by the proposed version of SA-CCR, which would essentially negate the value of the end-user margin exemption and undermine Congressional intent. The Agencies acknowledged these impacts in the proposal, noting “the exposure amount of unmargined derivatives contracts would increase by approximately 90%.”² Indeed, the proposal could increase pricing for end-users by five times their current costs.

- **Commodity Derivatives:** Companies enter into derivatives with banks to hedge their exposure to commodity price risk. Generally, for unmargined commodity derivatives with power, oil, or natural gas underliers, the potential future exposure (“PFE”) calculation for SA-CCR would rise to 56% of trade

¹ CFTC, Final Rule, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (January 6, 2016), available at: <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf>; U.S. prudential regulators, Final Rule, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840 (November 30, 2015), available at: <https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf>.

² See 83 Federal Register at 64,685 (December 17, 2018)

notional on a one-year swap from 10% today. More specifically, the total exposure, against which end-users must hold capital, for a one-year oil swap could increase by 425% under SA-CCR, as proposed.³

- **Foreign Exchange Derivatives:** Companies enter into derivatives with banks to hedge their foreign exchange (FX) risk on cash flows or payments that are in a foreign currency. The PFE for a one-year FX trade could increase by 460% under SA-CCR, as proposed.⁴
- **Interest Rate Derivatives:** U.S. state and local governments and some not-for-profit corporations enter into interest-rate swaps with banks to hedge variable interest rate exposure associated with publicly issued debt and private bank loans. The total exposure for a 25-year interest rate swap could increase by 66% under SA-CCR, as proposed.⁵

These increased capital costs for un-margined trades would be passed down to the end-users that use them, increasing their hedging costs, which would lead to increased costs for consumers in the real economy who depend on end-users' goods and services. Increased hedging costs may also subject end-users to increased cash flow volatility and increased credit risk for their lenders and investors. Additionally, increased capital costs could decrease overall liquidity in the markets, as some banks may choose to exit the market due to higher transaction costs. The Agencies must

³ For a one-year oil swap on 365,000 bbls total, struck at \$55/bbl, with \$0.50/bbl spot exposure: Current regulations would impose a 10% PFE weighting to the notional value of the contract, equal to \$2,190,000 total exposure. However, under SA-CCR, as proposed, the swap would be subject to a 56% PFE weighting, equal to \$11,497,500 total exposure, which represents a 425% increase in the exposure amount that the end-user counterparty must retain capital against.

⁴ For a one-year USD-EUR FX forward with a \$100,000 notional value: Current regulations would impose a 1% PFE weighting to the notional value of the contract, equal to \$1,000. However, under SA-CCR, as proposed, the transaction would be subject to a 5.6% PFE weighting, equal to \$5,600, which represents a 460% increase in the exposure amount that the end-user counterparty must retain capital against.

⁵ For a 25-year interest-rate swap with a \$162,500,000 notional value and \$46,421,879 market value: Current regulations would impose a 1.5% PFE weighting, equal to \$48,859,379 total exposure. However, under SA-CCR, as proposed, the swap would be subject to a 10.1% PFE weighting, equal to \$81,222,646 total exposure, which represents a 66% increase in the exposure amount that the end-user counterparty must retain capital against.

better align the SA-CCR methodology with existing end-user exemptions and default risk mitigation techniques in order to avoid these consequences.

2) **The Agencies should recognize client initial margin for purposes of the SA-CCR methodology within the supplementary leverage ratio framework.**

CCMC is supportive of the adoption of SA-CCR within the supplementary leverage ratio (SLR). However, the SLR framework should recognize the exposure-reducing effect of client initial margin (“IM”). The current lack of recognition has created a disincentive for central clearing, which is counterproductive to the G20 Leaders’ objective of promoting central clearing of standardized derivative contracts. According to data collected by FIA from 14 of the largest clearing members with regard to client cleared derivatives, “the aggregate leverage exposure of the 14 participating firms would be 80 percent higher under SA-CCR without an offset for initial margin than it would be using SA-CCR with an offset.” Further, FIA found that “clients that would be most adversely affected by the lack of an offset would be asset managers, insurers, and other end-users that use cleared derivatives to hedge risk.”⁶

The Basel Committee on Banking Supervision (“BCBS”) recently consulted on the leverage ratio’s treatment of client cleared derivatives and offered two proposed alternatives. CCMC commented on the consultation, supporting the BCBS’s options to offset the PFE for client cleared derivatives. Specifically, CCMC supported the option that would permit both cash and non-cash forms of initial margin and variation margin (“VM”) received from the client to offset replacement cost and the potential future exposure for client cleared derivatives. This option reflects existing market structure, given that in the cleared derivatives markets, both initial margin and variation margin offset client exposure. In addition, an offset for IM and VM would be in alignment with the measurement for risk-based capital requirements, providing consistency to market participants.

⁶ FIA, Response to Basel Leverage Ratio Consultation Regarding the Proposed Calculation of Centrally Cleared Derivatives Exposures Without Offset for Initial Margin and its Impact on the Client-Clearing Business Model, July 6, 2016

3) The Agencies should maintain the delta-weighting and offset for netting permitted under SA-CCR.

CCMC supports some of the changes proposed for exchange-traded products, but we do not believe these benefits outweigh the punitive capital costs imposed on other products, such as unmargined transactions with end-users. For example, the proposal includes improvements from CEM that permit for delta-weighting and a capital offset for netting sets to more appropriately account for counterparty credit risk. CCMC has endorsed these concepts noting it would “more accurately reflect the actual risk.”⁷ Furthermore, both changes are consistent with recommendations called for by the U.S. Department of the Treasury in their report on, “A Financial Systemic That Creates Economic Opportunities: Capital Markets.”⁸

CCMC supports the concept of delta-weighting for exchange-traded products. CEM does not permit for a delta adjustment for the notional value measurement of options. Delta-weighting takes into account the price sensitivity of the contract relative to changes in the price of the underlying asset. The proposal recommends the Black Scholes formula for calculating deltas; however, we do not believe this provides an accurate measurement for certain products. As an alternative, we recommend covered banks should be permitted to use their own internally calculated deltas. We believe the delta-adjustment will provide meaningful relief from the risk and leveraged-based capital framework for market participants who rely on options to hedge their positions.

CCMC also supports a capital offset for netting sets. The Treasury’s October 2017 Report on Capital Markets notes, “The CEM methodology measures exposures on a gross basis and is, therefore, overly restrictive in permitting netting and the offsetting of long and short positions. . . . When done through the same CCP, the risk of such hedged positions is reduced, or even eliminated,” and recommends a

⁷ Letter from the Chamber of Commerce to the House Financial Services Committee. June 13, 2018. Available at https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/06/6.13.18_HFSCMarkup.pdf?#

⁸ U.S. Department of the Treasury, “A Financial System That Creates Economic Opportunities: Capital Markets” (October 2017), available at <https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf>

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“recognition of appropriate netting sets and hedged positions.”⁹ CCMC is concerned that certain exchange-listed equity futures may be considered unmargined derivatives contracts for purposes of the netting rules. If so, this will prevent exchange-listed equity options from netting with exchange-listed equity futures, potentially disrupting important hedging relationships in the exchange-traded marketplace. It is important that the proposal fully recognize these important, economically meaningful relationships to prevent SA-CCR from causing negative unintended consequences in those markets.

Thank you for the opportunity to comment on the proposal. We encourage the Agencies to ensure SA-CCR recognizes existing end-user exemptions as well as market structure to avoid unintended consequences.

Sincerely,

A handwritten signature in black ink, appearing to read 'T. Quaadman', with a stylized flourish extending to the right.

Tom Quaadman

⁹ Ibid.