



January 16, 2024

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

Re: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies

Dear Ms. Misback:

The Futures Industry Association (“FIA”)¹ is writing to express our serious concerns with the significant increase in capital requirements for client derivatives clearing activities that the Board of Governors of the Federal Reserve System (“Board”) has proposed in its notice of proposed rulemaking to revise the calculation methodology for the capital surcharge that applies to U.S. global systemically important banking organizations (“G-SIBs”) and the FR Y-15 reporting form (the “Surcharge Proposal”).²

Board Chair Jerome H. Powell has stated that global regulators “have a responsibility to ensure that bank capital standards and other policies do not unnecessarily discourage central clearing.”³ The Surcharge Proposal would do exactly what Chair Powell warned not to do. Since the inception of the G-SIB Surcharge in the United States, its Complexity and Interconnectedness indicators have excluded transactions in which a clearing member G-SIB, acting as agent for a client’s OTC derivative trade, guarantees the client’s performance to a central counterparty (“CCP”) but does not guarantee the CCP’s performance to the client. These exclusions make good sense. Central clearing of OTC derivatives makes the financial markets

¹ FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA’s membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. FIA’s mission is to: support open, transparent and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA’s clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

² 88 Fed. Reg. 60,385 (Sept. 1, 2023).

³ Federal Reserve Board Governor Jerome H. Powell, Central Clearing and Liquidity, Speech at the Federal Reserve Bank of Chicago Symposium on Central Clearing, Chicago, Illinois (June 23, 2017), available at <https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm>.

less complex, results in fewer parties being exposed to or interconnected with G-SIBs, and generally promotes systemic stability.

In the Surcharge Proposal, the Board has proposed to add many more of these transactions – including virtually all OTC derivatives transactions that U.S. G-SIBs clear in the United States – to the calculation of the Complexity and Interconnectedness indicators of the G-SIB Surcharge. In doing so, the Board would dramatically increase capital requirements for the client OTC clearing activities of U.S. G-SIBs. The Surcharge Proposal’s proposed increases to capital requirements for client OTC clearing would be exacerbated by additional capital increases for this activity that the Board, OCC, and FDIC have jointly proposed in their separate notice of proposed rulemaking to implement the Basel III Endgame rules (the “Endgame Proposal,”⁴ and together with the Surcharge Proposal, the “Proposals”).

As described in further detail below, a quantitative impact study of our member firms⁵ shows that the two Proposals would collectively increase the capital required to engage in client clearing activities by more than **80 percent**. The Surcharge Proposal’s changes to the treatment of client cleared OTC derivatives transactions would, on their own, increase the capital required to engage in client clearing activities by more than **58 percent**.

Figure 1: Capital Requirement Attributable to Six U.S. G-SIBs’ Client Clearing Activity as of June 30, 2023⁶

	Capital Requirement Expressed in Dollars (billions)	Percentage Increase in Capital Requirement
Current U.S. Standardized Approach	\$8.96	N/A
Net Increase from Endgame Proposal	\$2.01	22.4%
Net Increase from Surcharge Proposal	\$5.20	58.1%
Total Net Increase from Proposals	\$7.21	80.5%

These increases in capital requirements could decrease end users’ access to clearing services, lead to increased prices for end users, and increase systemic risk – all while ignoring the Board’s prior stated reasons for excluding client cleared transactions conducted under the agency model from the Complexity and Interconnectedness indicators, which remain as valid as ever. We are very concerned about the absence of any apparent cost-benefit analysis that considers these important negative impacts of the Proposals on systemic stability and on end

⁴ 88 Fed. Reg. 64,028 (Sept. 18, 2023).

⁵ The data collection and analysis for this quantitative impact study was conducted by the GARP Benchmarking Initiative (GBI)®, a division of the Global Association of Risk Professionals® (GARP). GARP®, a nonpartisan, non-profit corporation, is the world’s leading professional association for risk managers, dedicated to the advancement of the profession through education, research, and the promotion of best practices. GARP does not lobby, take advocacy positions, or engage in any advocacy related to the data it collects and analyzes.

⁶ Our calculation methodology is described further below in this letter. See n. 19, 30, and 34.

users such as agricultural businesses, insurance companies, and pension funds. In fact, the Surcharge Proposal does not include any specific estimate of the impact on capital requirements arising from these changes to the Complexity and Interconnectedness indicators, let alone the cumulative impact on client clearing activities from the Proposals' changes.

Part I of this letter provides background on client OTC derivatives clearing activities and describes why such activities decrease U.S. G-SIBs' systemic footprints. Part II discusses our concerns with the Surcharge Proposal's changes to the treatment of derivatives clearing activities and explains why the Board should not finalize those changes. Finally, the Appendix to this letter answers specific questions that the agencies have asked in the Surcharge Proposal preamble.

I. Client Clearing Is Fundamentally a Low-Risk Activity That Does Not Meaningfully Contribute to a U.S. G-SIB's Systemic Footprint and That Reduces the U.S. G-SIB's Systemic Footprint Compared to Bilateral Trading

Globally, banking organizations clear OTC derivatives for their clients under two models. Under the agency model, a banking organization acts as agent for its client, which enters into the derivative directly with a CCP. The banking organization typically guarantees the client's performance to the CCP, but not the CCP's performance to the client. Under the principal model, a banking organization enters into equal and offsetting trades as principal directly with the client and the CCP.⁷ The agency model is the dominant method of client clearing for OTC derivatives. As discussed below, more than 80 percent of the notional amount of swaps cleared through LCH are cleared using the agency model – and over 90 percent of all interest rate swaps cleared globally clear through LCH.

Several features of client clearing reduce the risks that clearing members face. First, on a daily or twice-daily basis, the client is either required to post variation margin in the form of cash to secure the full amount that it is out of the money on the derivative on a mark-to-market basis (in a "Collateralized to Market" or "CTM" trade) or is required to provide an equivalent cash payment to settle the derivative (in a "Settled to Market" or "STM" trade). In this way, variation margin or settlement payments eliminate the clearing member's actual current exposure to the client at the time the variation margin is posted or payment is made. Because of the daily or twice-daily posting of margin or exchange of settlement payments, the clearing member remains exposed only to the possibility that market values will move in excess of the client's posted margin during the one day or half a day since the last posting of variation margin or exchange of settlement payments, and the client fails to post that incremental value.

Second, the client is also required to post initial margin in the form of cash or highly liquid securities to further secure the clearing member's exposure to movement in market prices. The amount of initial margin the client will be required to post depends on the volatility of the OTC derivative. Clients generally post initial margin in excess of the expected change in value

⁷ Similarly to the agency model, in the principal model, the banking organization typically does not take on liability for the CCP's performance to the client.

of the client's position, which for cleared swaps must be calculated with a 99 percent confidence interval over a close-out period of at least five days. Clearing members also often have a contractual right to call additional initial margin. In this way, initial margin reduces the clearing member's actual potential future exposure.

Third, while clearing members do agree to mutualize losses that would arise from the default of a clearing member, they pre-fund such loss mutualization with default fund contributions. CCPs' own capital and other safeguards further limit losses that clearing members could be forced to incur. The mutualization of losses would only be required if the defaulter's initial margin, clearing members' aggregate default fund contributions, and CCP capital prove insufficient.

In sum, a clearing member operating in the agency model is well-protected against the risk that its client would default on its obligation to the CCP without having posted sufficient margin to cover the client's payment obligation, requiring the clearing member to perform on its guarantee to the CCP. And as described below, this residual risk is already capitalized in the G-SIB Surcharge and other parts of the existing regulatory capital framework.

Central clearing also reduces the systemic risk that arises from a G-SIB's OTC derivatives transactions. It does so by facilitating the transfer (or "port") of the positions (and collateral) of a defaulting clearing member's clients to other, financially sound clearing members in a simple and rapid manner, with the goal of preserving the end-users' positions while protecting any collateral pledged. As Chair Powell has recognized,⁸ porting reduces clients' exposure to counterparty default losses, which strengthens the resilience of the banking system by:

- discouraging counterparties from participating in destabilizing runs on banks;
- reducing the cascade of defaults that can result from clients incurring losses or going unhedged; and
- limiting losses to banks that are themselves clients of the affected clearing member.

Because of the availability of porting, a G-SIB should be able to fail, and its client cleared derivatives book transferred to other market participants, in a manner that is far more orderly than would be the case in the absence of central clearing. In turn, G-SIBs' capacity to take on the book of business of a defaulting clearing member helps reduce, *ex ante*, the risk of a

⁸ Federal Reserve Board Governor Jerome H. Powell, Central Clearing and Liquidity, Speech at the Federal Reserve Bank of Chicago Symposium on Central Clearing, Chicago, Illinois (June 23, 2017), available at <https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm> ("Central clearing serves to address many of the weaknesses exposed during the crisis by fostering a reduction in risk exposures through multilateral netting and daily margin requirements as well as greater transparency through enhanced reporting requirements. Central clearing also enables a reduction in the potential cost of counterparty default by facilitating the orderly liquidation of a defaulting member's positions, and the sharing of risk among members of the CCP through some mutualization of the costs of such a default.").

destabilizing run on the financial system. But porting only works if banks have this capacity. As described in the remainder of this letter, we have serious concerns that if the Surcharge Proposal is finalized as proposed, the G-SIB Surcharge could substantially reduce capacity for client porting in the market, and thus undermine the many benefits of porting to financial stability.

II. The Board Should Not Finalize Its Proposal to Add OTC Derivatives Clearing Under the Agency Model to the Complexity and Interconnectedness Indicators, Which Would Increase Capital Requirements for OTC Derivatives Clearing, Have Negative Effects for End Users, and Impede Portability

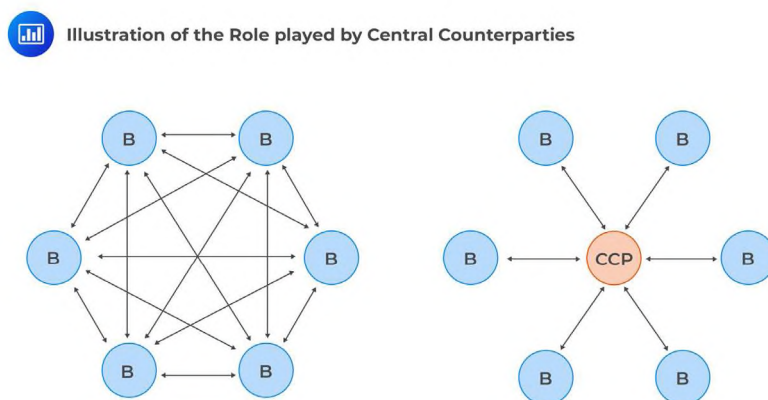
In the Surcharge Proposal, the Board has proposed to add exposures arising from a G-SIB's role as clearing member operating in the agency model in OTC derivatives transactions to the Complexity and Interconnectedness indicators "[t]o promote consistent treatment of the two clearing models."⁹ We strongly oppose this misguided increase in capital requirements for client OTC derivatives clearing activities for several reasons.

A. Client clearing reduces the complexity and interconnectedness of G-SIBs and the financial system

1. Client clearing reduces the complexity of G-SIBs and the financial system

Client clearing decreases the complexity of the OTC derivatives markets and the financial institutions that facilitate OTC derivatives transactions. It does so by reducing bespoke bilateral arrangements with a more standardized and transparent system of transactions with a CCP, as depicted in Figure 2:

Figure 2: Depiction of Effect of Clearing on Ties Among Market Participants



⁹ 88 Fed. Reg. at 60,392.

As the DAT recognized, “A key advantage is that by having the CCP as the counterparty of each trade it clears, multilateral netting of each clearing member’s exposure to the others is facilitated in a legally and operationally robust and efficient manner. The risk reduction created by multilateral netting is both a private benefit (in that it reduces clearing member exposure and margin requirements compared to an uncleared counterfactual), and a social benefit, in that *it makes the OTC derivatives system (and other centrally cleared markets) less complex* and potentially less prone to contagion.”¹⁰ Additionally, clearing concentrates risk within a CCP, which serves as a focal point for regulation and supervision.¹¹

The Board has made clear that the Complexity indicators were primarily intended to capture barriers to resolvability.¹² By this standard, there is no basis for treating client OTC clearing activity the same as bilateral OTC transaction activity in the Complexity indicators, as the Surcharge Proposal would do. As noted above, client clearing vastly reduces barriers to resolving a U.S. G-SIB because it allows for a rapid port of the G-SIBs’ client positions. Client clearing also serves to standardize OTC derivatives trading along many dimensions – including legal documentation, risk management practices, and reporting – and thus reduces barriers to resolution that could arise from more fragmented and bespoke market practices.

2. Client clearing reduces the interconnectedness of G-SIBs and the financial system

Client clearing of OTC derivatives also decreases the interconnectedness of individual U.S. G-SIBs and of the financial system. The Board has described the Interconnectedness indicator of the G-SIB Surcharge as capturing the likelihood that “financial distress at a G-SIB may materially raise the likelihood of distress at other firms.”¹³ By this measure, client clearing greatly reduces the interconnectedness of each U.S. G-SIB when compared to bilateral OTC

¹⁰ DAT Report at p. 56 (emphasis added).

¹¹ The SEC recently cited the benefits of central clearing when it adopted final rules to require the central clearing of U.S. Treasury securities. *See* SEC Final Rule, Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities, *available at* <https://www.sec.gov/files/rules/final/2023/34-99149.pdf>; SEC Chair Gary Gensler, Statement on Final Rules Regarding Treasury Clearing (Dec. 13, 2023), *available at* <https://www.sec.gov/news/statement/gensler-statement-treasury-clearing-121323> (“While central clearing does not eliminate all risk, it does lower it. First, clearinghouses do so by sitting in the middle and reducing all the risks amongst and between counterparties. They also provide multi-party netting, which helps lower the overall margin (collateral) needed to be posted in the system. Further, central clearing reduces risks through the robust rules of the clearinghouses themselves, including for the collection of initial and variation margin.”).

¹² 80 Fed. Reg. 49,082, 49,096 (Aug. 14, 2015) (preamble to final G-SIB Surcharge rule stating “Generally, the more complex a banking organization is, the greater the expense and time necessary to resolve it Resolvability and organizational complexity are important contributors to the potential systemic effects of a GSIB default and the complexity indicators included in the methodology seek to reflect this in a quantifiable way”).

¹³ 79 Fed. Reg. 75,473, 75,485 (Dec. 18, 2014).

derivative arrangements, because it reduces the number of counterparties that are exposed to a clearing member.¹⁴ Clients have lower exposure to their clearing members, including in the event of failure of the clearing member, than they would to a counterparty bank in a bilateral trade, because in a cleared OTC derivative transaction under the agency model, the client's counterparty is the CCP, and because the margin the client posts is segregated from the proprietary funds of the clearing member and CCP.¹⁵ Further, client clearing results in each individual G-SIB being less interconnected with other firms, compared to when the G-SIB enters into bilateral derivatives with clients. Yet, the Surcharge Proposal would treat client cleared OTC derivative trades as creating the same level of interconnectedness as bilateral OTC derivative trades – an outcome that would be inconsistent with the Board's description of the Interconnectedness indicator.¹⁶

* * *

The Board has not presented any evidence demonstrating that acting as a clearing member in OTC derivatives transactions increases a U.S. G-SIB's systemic risk, either through additional complexity or interconnectedness, which is a predicate requirement for a rulemaking like the Surcharge Proposal.¹⁷ Further, to the extent that a U.S. G-SIB's clearing of OTC derivatives increases the risk that the firm presents to the financial system, the Board has not demonstrated that such risk is not already captured within the Size indicator and should be

¹⁴ See Froukelien Wendt, *Central Counterparties: Addressing their Too Important to Fail Nature*, IMF Working Paper, p. 6 (Jan. 2015), available at <https://www.imf.org/external/pubs/ft/wp/2015/wp1521.pdf> (“The establishment of a CCP reduces the interconnectedness of banks. A CCP guarantees the performance of open positions despite the failure of one of the clearing members. In that sense a CCP that is well designed and capitalized insulates counterparties from one another. In its role of firewall a CCP can be considered a prudential tool to reduce the interconnectedness among banks.”).

¹⁵ Moreover, any interconnectedness that results from the mutualization of losses in the central clearing model is substantially curtailed by a waterfall of risk mitigants that include robust amounts of initial margin, pre-funded default fund contributions, CCP capital, and other safeguards. See, e.g., 17 C.F.R. § 39.13(g)(2)(iii) (requiring CCPs to establish initial margin requirements sufficient to cover their potential future exposures to clearing members over a specified liquidation time with an established confidence level of 99 percent). This waterfall structure greatly reduces the probability that other clearing members would suffer losses due to a clearing member's default, as well as the potential impact of any such losses. A CCP can endure “truly extreme” losses without clearing members being required to make additional contributions to the CCP. See CME Group, *Balancing CCP and Member Contributions with Exposures*, at p. 4 (Aug. 18, 2017), available at <http://www.cmegroup.com/education/balancing-ccp-and-member-contributions-with-exposures.html>.

¹⁶ While clearing mandates compel the clearing of certain products, other products, such as energy derivatives, are offered as cleared and bilateral transactions.

¹⁷ Under the APA, an agency must “examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made.” *Motor Vehicle Mfrs. Assn. v. State Farm Mut. Ins. Co.*, 463 U.S. 29, 42–43 (1983) (internal quotations omitted).

counted in the same manner as the systemic risk resulting from entering into bilateral OTC derivatives, as the Proposal would do.

B. The G-SIB Surcharge and many other parts of the regulatory capital framework already count exposures arising from derivatives clearing activities

As a threshold matter, any systemic risk resulting from a clearing member G-SIB's guarantee of its client's obligation to a CCP in an OTC derivatives transaction is already captured in the G-SIB Surcharge through the Size indicator, and the Board has not offered any contrary analysis. The Surcharge Proposal would therefore *triple count* exposures arising from this guarantee within the G-SIB Surcharge – and that is before considering the many other parts of the capital rules that also count these exposures.

Even apart from the G-SIB Surcharge, the U.S. capital rules currently impose many overlapping layers of capital requirements relating to derivatives clearing activities. These requirements include:

- Risk-based capital requirements for, among other things:¹⁸
 - counterparty credit risk requirements, currently in the form of Standardized Approach to Counterparty Credit Risk (“SA-CCR”) for large banks; and
 - CCP default fund contributions.
- Leverage capital requirements for counterparty credit risk and the on-balance sheet portion of margin, in the form of the Supplementary Leverage Ratio (“SLR”) and “enhanced” Supplementary Leverage Ratio (“eSLR”).

Due to these overlapping and significant capital requirements, U.S. G-SIBs already maintain substantial capital levels to support their OTC derivatives clearing businesses. A quantitative impact study of six U.S. G-SIBs that are significant clearing members in the United States, using data as of June 30, 2023, indicates that the U.S. standardized approach currently requires these six firms to maintain over \$8.96 billion in capital solely to engage in client

¹⁸ The existing capital rules also include potential capital charges for OTC derivatives clearing within the advanced approaches rule through CVA risk and operational risk, and the Endgame Proposal's expanded risk-based approach would likewise capture these transactions in its CVA risk and operational risk frameworks. However, as discussed in FIA's separate comment letter on the Endgame Proposal, the continued inclusion of exposures from OTC derivatives clearing in the CVA risk framework is not warranted, and the proposed method of calculating operational risk vastly overstates the operational risk arising from this activity.

clearing activities.¹⁹ These levels of capitalization are already outsized to the modest risks that OTC derivatives clearing activity poses to U.S. G-SIBs and the financial system.²⁰

The Board has not established that the multiple layers of regulatory capital requirements that apply to U.S. G-SIBs' client clearing activities do not adequately capture the risk arising from the clearing member's guarantee in a client cleared OTC derivative transaction. In this context, it is wholly unnecessary to add OTC derivatives transactions cleared for clients in the agency model to the Complexity and Interconnectedness indicators to ensure that U.S. G-SIBs maintain sufficient capital against these exposures.

C. Adding transactions conducted under the agency model to the Complexity indicator would be a significant and unnecessary deviation from the international standard

The Basel Committee on Banking Supervision's latest reporting instructions for the international G-SIB Surcharge assessment exclude from the Complexity indicator cleared OTC derivative transactions in which a clearing member G-SIB, acting as agent, does not guarantee the performance of a CCP to its client.²¹ By proposing to impose significantly higher capital requirements than the international standard through the inclusion of such transactions within the Complexity indicator of the U.S. G-SIB Surcharge, the Surcharge Proposal would needlessly place U.S. G-SIBs at a disadvantage to their competitors based abroad.²² Such a competitive

¹⁹ We calculated this figure by multiplying the six firms' risk-weighted assets attributed to client clearing activities in the current U.S. standardized approach by these firms' capital requirements, which are comprised of the minimum capital requirement, stress capital buffer requirement, and G-SIB Surcharge capital requirement. Except where indicated elsewhere in this letter, our impact assessment is based on data reported in the quantitative impact study.

²⁰ For instance, the SA-CCR framework does not fully take into account the risk-reducing effect of initial margin. See Michael Roberson, CFTC Risk Analyst, *An Empirical Analysis of Initial Margin and the SA-CCR (2018)*, available at <https://www.cftc.gov/sites/default/files/2018-07/SA-CCRPaper0718.pdf>.

²¹ Basel Committee on Banking Supervision, *Instructions for the end-2022 G-SIB assessment exercise*, ¶ 128 (Jan. 2023), available at https://www.bis.org/bcbs/gsib/instr_end22_gsib.pdf ("Do not include cleared derivative transactions (ie transactions where the bank provides clearing services for clients executing trades via an exchange or with a CCP) where the bank is not a direct counterparty in the contract In cases where a clearing member bank, acting as an agent, guarantees the performance of a CCP to a client, the associated notional amounts must be reported.").

²² It is far from clear that there would be international consensus in favor of adding derivatives cleared under the agency model to the Complexity indicator. The Basel Committee stated in the very first G-SIB Surcharge consultative document and final standard in 2011 that "[t]he focus here is on the amount of OTC derivatives that are not cleared through a central counterparty. The greater the number of non-centrally cleared OTC derivatives a bank enters into, the more complex a bank's activities." See Basel Committee on Banking Supervision, *Consultative Document, Global systemically important banks: Assessment methodology and the additional loss absorbency requirement* at p. 9 (July 2011), available at <https://www.bis.org/publ/bcbs201.pdf>; Basel Committee on Banking Supervision, *Global systemically (continued...)*

imbalance could distort the OTC derivatives clearing markets and shift clearing activity to institutions that are not regulated in the same manner or to the same degree as U.S. G-SIBs – assuming there is even capacity among such institutions to take on additional clearing business.

This concern is particularly acute because the U.S. G-SIB Surcharge rule is *already* more conservative than the international G-SIB Surcharge, including through the use of Method 2, which generally produces higher capital requirements than the standards that apply to G-SIBs based outside the United States.²³

D. The Surcharge Proposal contravenes the Board’s prior decisions and reasoning, without adequately explaining why the Board is departing from the principles it has articulated

The Surcharge Proposal is inconsistent with the Board’s prior reasoning for excluding client clearing from the Complexity and Interconnectedness indicators. In 2017, the Board proposed to make the same changes that the Board proposes today – *i.e.*, to include within the Complexity and Interconnectedness indicators OTC derivative transactions where a U.S. G-SIB, acting as agent, guarantees its client’s performance to the CCP. The Board ultimately decided the following year not to finalize such changes. It explained its reasoning for not adding transactions under the agency model as follows:

[P]art of the motivation for including the client leg of the agency model was to make sure that, for a regulatory framework that encompasses multiple models of clearing, no one model receives significantly more or less representation with respect to the GSIB indicators. The proposal was intended in part to ensure that the agency model would be adequately included in the GSIB indicators compared to the principal model. However, the expansion in the availability and overall use of the agency model somewhat mitigates concerns about the relative treatment of client-cleared transactions between respondents, and the Board is thus not currently concerned that excluding the client leg from the GSIB indicators will result in a significant disparity among reporters. Because the two clearing models remain, however, the Board may

important banks: assessment methodology and the additional loss absorbency requirement, Rules text, p. 9 (Nov. 2011), *available at* <https://www.bis.org/publ/bcbs207.pdf>.

²³ Method 2 is a U.S.-specific methodology for calculating the G-SIB Surcharge, compared to Method 1, which generally follows the internationally-agreed standard. Method 2 measures a bank holding company’s systemic risk profile using the same systemic indicators as Method 1, except that the substitutability category is replaced with a measurement of reliance on short-term wholesale funding. Method 2 generally results in higher capital requirements than Method 1.

need to address inequitable treatment of client-cleared transactions in the future if the principal model again becomes more common.²⁴

In other words, the Board proposed in 2017 to add OTC derivative clearing activity under the agency model for the same reason offered in the Surcharge Proposal: to eliminate the apparent discrepancy in the treatment of the agency model and the principal model. And upon learning that most OTC derivative clearing occurs or can occur under the agency model, the Board determined that it would not be appropriate to equalize the treatment of transactions cleared under the agency model and principal model, presumably because, as a practical matter, that would amount to imposing additional capital requirements for OTC derivatives clearing.

Today, the agency model remains the predominant form of clearing for OTC derivatives globally, and the only model used in the United States. LCH has reported to FIA that in the first half of 2023, over 80 percent of OTC derivatives, measured by notional amount, cleared through LCH under the agency model.²⁵ The principal model has not grown in the United States, as U.S. futures commission merchants (“FCMs”) are only permitted to clear OTC derivatives for their clients under the agency model²⁶ and U.S. persons are only allowed to obtain clearing services from U.S. FCMs.²⁷ Therefore, by the Board’s own standard, there is no reason to add OTC derivative transactions cleared under the agency model to the Complexity and Interconnectedness indicators at this time.²⁸

Troublingly, the Surcharge Proposal shows no awareness of this prior history. The Board’s failure to reconcile its prior conclusions with the fact that the OTC derivatives clearing markets have not materially changed since it made those conclusions raises the question of whether this aspect of the Surcharge Proposal would comport with the Administrative Procedure Act if finalized.²⁹

The dominance of the agency model of clearing also underscores how significant a change the Board is proposing in the Surcharge Proposal. The Surcharge Proposal purports to be an attempt to equalize the treatment of agency transactions and principal transactions. But this rationale has very little force given that U.S. G-SIBs have relatively low volumes of clearing

²⁴ 83 Fed. Reg. 31,144, 31,145 (July 3, 2018).

²⁵ Over 90 percent of all interest rate swaps cleared globally clear through LCH. Of the OTC interest rate swaps cleared through LCH under the agency model, 45 percent of clients (measured by number of clients) are domiciled outside of the United States.

²⁶ *See, e.g.*, 17 C.F.R. § 39.12(b)(6)(ii).

²⁷ *See* 7 U.S.C. § 6d(f)(1).

²⁸ To the extent that clearing under the principal model has grown globally, that growth would be the result of clearing mandates becoming effective in Europe, where the principal model remains the primary model for clearing at this time.

²⁹ *See* *Fox v. FCC*, 129 S. Ct. 1800, 1811 (2009) (“[T]he [APA’s] requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it *is* changing position.”).

under the principal model. U.S. FCMs are only permitted to clear OTC derivatives for their U.S. clients under the agency model, and many non-U.S. persons also elect to access clearing services in the agency model. Instead, the Surcharge Proposal would effectively amount to the Board subjecting the OTC derivatives client clearing business to the Complexity and Interconnectedness indicators largely for the first time.

E. The Board has failed to take account of the significant negative costs of the Surcharge Proposal's inclusion of OTC derivatives clearing within the Complexity and Interconnectedness indicators

While the Surcharge Proposal does not include a specific impact assessment regarding its proposed changes to the treatment of client clearing of OTC derivatives, FIA members have performed a data collection and analysis to determine the impact. This analysis shows that increases in capital requirements due to the inclusion of OTC derivatives clearing activities under the agency model within the Complexity and Interconnectedness indicators would be significant for clearing businesses. Indeed, for most U.S. G-SIBs that clear OTC derivatives, the impact would be significant to the entire banking organization.

As noted above, the current U.S. standardized approach requires six firms that are U.S. G-SIBs and significant clearing members to maintain over \$8.96 billion in capital solely to engage in client clearing activities. The proposed changes to the G-SIB Surcharge would increase the capital required for these six firms to engage in their current scope of client clearing activities by **58 percent**, or over **\$5.20 billion** in the aggregate.³⁰

Five U.S. G-SIB quantitative impact study participants reported more than negligible increases to their Method 2 G-SIB Surcharge scores as a result of the inclusion of client cleared OTC derivatives cleared under the agency model in the Complexity and Interconnectedness indicators. Of these five participants, the inclusion of such transactions in the Complexity indicator would increase their Method 2 scores by an average of 13.9 points, and the inclusion of

³⁰ We calculated this capital impact of \$5.20 billion by reflecting the changes to the six participating firms' Method 2 G-SIB Surcharge scores arising from the Surcharge Proposal's changes to the treatment of client clearing activities. Specifically, the net increase takes account of the increases to these firms' Method 2 scores arising from the proposed inclusion of client OTC clearing under the agency model to the Complexity and Interconnectedness indicators as well as a modest decrease to Method 2 scores attributable to client clearing activities arising from the incorporation of SA-CCR into the Interconnectedness indicator. For purposes of calculating the impact of changes to the Interconnectedness score, participating firms assumed that the alpha factor in the version of SA-CCR used in Interconnectedness indicator would be 1.0, which is consistent with industry recommendations but provides more conservative (lower) projected impact than if the Board decided to apply an alpha factor of 1.4, as proposed. We translated this Method 2 score increase into a G-SIB Surcharge capital requirement increase by dividing the score increase by 20 and multiplying by 10 basis points (which is the size of the increase in capital requirement for each 20 point increase in Method 2 score). We then multiplied this projected increase in capital requirement by the total risk-weighted assets for the participating firms, calculated under the Endgame Proposal's expanded risk-based approach, to arrive at the aggregate capital impact for the six firms.

these transactions in the Interconnectedness indicator would increase their Method 2 scores by an average of 0.9 points.³¹

The preamble to the Surcharge Proposal does not acknowledge these significant increases in Method 2 scores and overall capital requirements attributable to client clearing businesses, and instead states that the Board projects that the Surcharge Proposal *as a whole* would only cause an average *firmwide* increases in Method 2 scores of 27 points and aggregate *firmwide* increases in required capital of \$13 billion.³² Further, the preamble states that the largest contributors to the projected increase in Method 2 scores would come from including derivatives exposures in the Cross-Jurisdictional Activity indicators (11 points) and averaging various data points underlying the indicators (9 points). But both of those projected increases are smaller in magnitude than the impact that our members' quantitative impact study shows would result from including client cleared OTC derivatives cleared under the agency model in the Complexity and Interconnectedness indicators.³³ These figures suggest that the Board has failed to consider the true impact of the Surcharge Proposal's changes on client clearing businesses.

The Surcharge Proposal also should be considered together with the Endgame Proposal, which would further increase capital requirements for clearing client derivatives. The Endgame Proposal's expanded risk-based approach would increase the capital required of the six U.S. G-SIBs participating in our members' quantitative impact study to engage in client clearing activities by more than **22 percent**, or over **\$2.01 billion** in the aggregate.³⁴ **Collectively, the two Proposals would increase the six firms' capital requirements for client clearing activities by more than 80 percent, or over \$7.21 billion in the aggregate.**

³¹ Across all six U.S. G-SIBs participating in the quantitative impact study, the inclusion of client clearing transactions under the agency model within the Complexity indicator would increase Method 2 scores by an average of 11.6 points, and the inclusion of these transactions within the Interconnectedness indicator would increase Method 2 scores by an average of 0.8 points.

³² 88 Fed. Reg. at 60,397.

³³ See n. 31 and accompanying text, above.

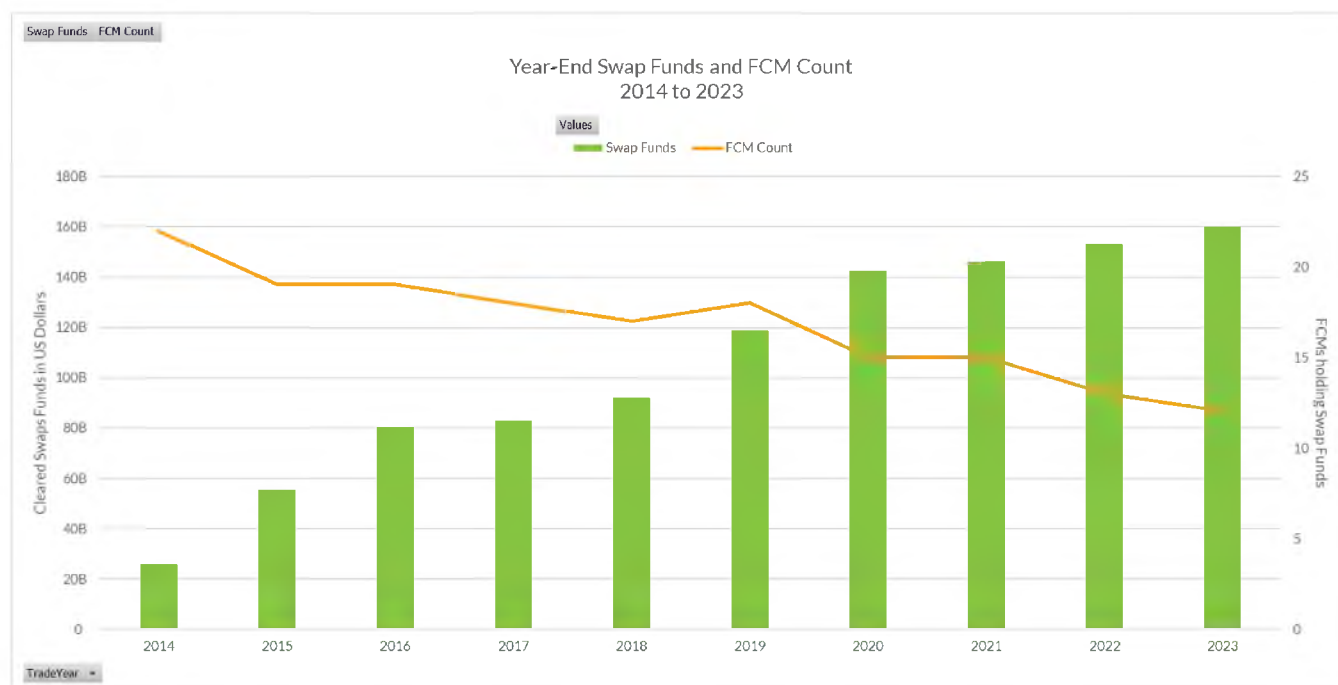
³⁴ Our calculation of the pro forma capital impact of the Endgame Proposal reflects the higher risk-weighted assets required for client clearing under the expanded risk-based approach compared to the current U.S. standardized approach, as well as proposed increases in firms' minimum capital requirements arising from the Proposals' changes to the stress capital buffer and certain changes to the G-SIB Surcharge. Specifically, our calculation assumes an increase in firms' capital requirements of 10 basis points due to changes in the firmwide G-SIB Surcharge requirement, reflecting the Board's estimated increase of 11 Method 2 score points due to the inclusion of derivative exposures in Cross-Jurisdictional Activity indicators, and the Board's estimated increase of 9 Method 2 score points due to the effect of averaging the indicators. See 88 Fed. Reg. at 60,397. To avoid a double-count when we present the cumulative impact of the Proposals, our calculation of the impact of the Endgame Proposal excludes proposed changes to the G-SIB Surcharge that would directly impact client clearing, such as including client OTC derivatives cleared under the agency model in the Complexity and Interconnectedness indicators.

These increases in capital requirements will have several negative externalities for market participants.

1. Clients Would Face Barriers to Accessing Cleared OTC Derivatives, Including Reduced Availability and Higher Costs

When Dodd-Frank Act reforms became effective in 2014, there were 22 FCMs providing OTC client clearing services in the United States.³⁵ Today, there are 12 clearing firms, with 7 of these firms comprising 94 percent of the market, as shown in Figures 3 and 4 below:³⁶

Figure 3: Comparison of Customer Funds in Swap Accounts and Number of FCMs³⁷

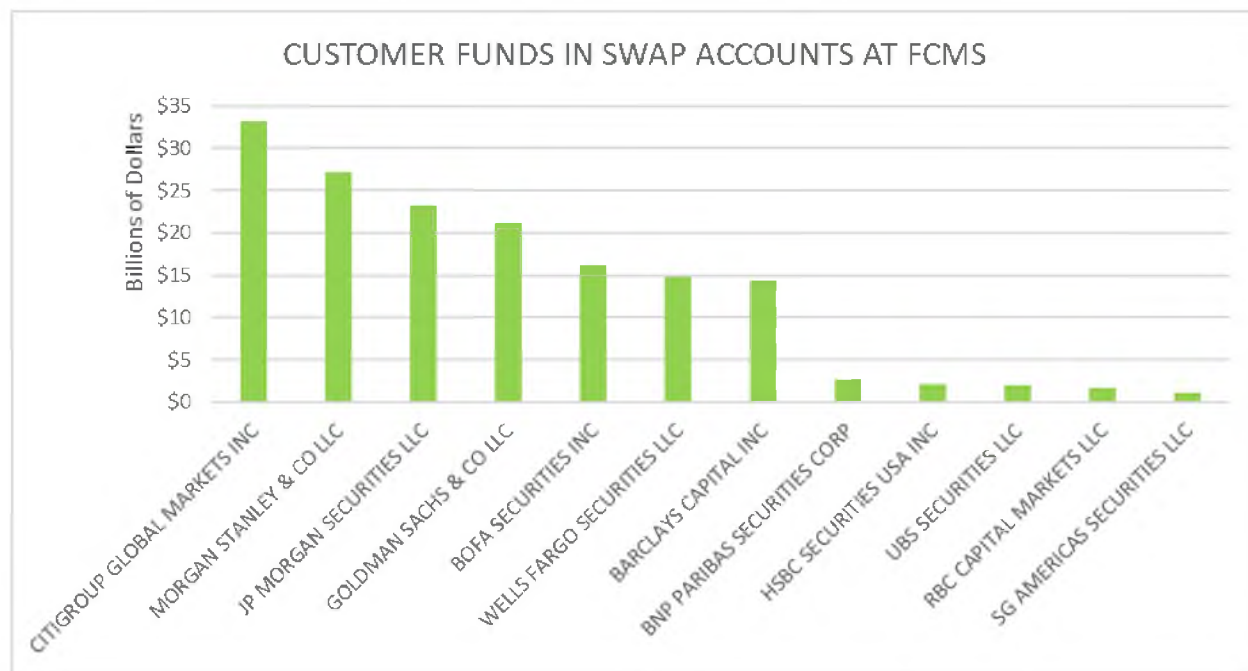


³⁵ See Commodity Futures Trading Commission, Financial Data for FCMs, available at <https://www.cftc.gov/MarketReports/financialfcmdata/index.htm>.

³⁶ See *id.*

³⁷ Source: FIA FCM Tracker, based on CFTC Data Published as of July 2023, available at <https://www.fia.org/articles/fcm-tracker>.

Figure 4: Share of the Swaps Clearing Business³⁸



The bulk of the market exits from the clearing business occurred during a period when a specific capital requirement – the SLR – imposed a disproportionately high capital charge on OTC derivatives clearing activities.³⁹ These market exits are all the more notable given that over the same timeframe, policymakers implemented clearing mandates globally that have increased the aggregate volume of clearing, as exemplified in Figure 3, above.

Further increases in capital would significantly disincentivize U.S. G-SIBs from clearing OTC derivatives, which, in turn, would harm end users seeking to use cleared OTC derivatives to hedge their risks. Specifically, the proposed inclusion of clearing activity in the Complexity and Interconnectedness indicator would increase the likelihood that a client clearing business is responsible for tipping its entire firm into a higher G-SIB Surcharge bucket and thus increase the firmwide capital requirement.⁴⁰ As noted above, the inclusion of client cleared OTC derivatives cleared under the agency model in the Complexity indicator would increase the Method 2 G-SIB Surcharge scores of five U.S. G-SIBs that are significant clearing members by an average of 13.9 points, and the inclusion of these transactions in the Interconnectedness indicator would increase

³⁸ Source: FIA FCM Tracker, based on CFTC Data Published as of July 2023, available at <https://www.fia.org/articles/fcm-tracker>.

³⁹ DAT Report at pp. 20-21.

⁴⁰ The Surcharge Proposal's narrowing of the Method 2 score bands from 100 to 20 would further increase the likelihood of the clearing business tipping the entire firm into a higher capital requirement bucket, though the impact of that tipping would be correspondingly lower.

their Method 2 scores by an average of 0.9 points. That dynamic would make firms even more likely to scale back their clearing activity.

In response to the Surcharge Proposal and the Endgame Proposal, some U.S. G-SIB clearing members could exit the market entirely. Other U.S. G-SIBs may be less likely to take on new clients for OTC derivatives clearing, or could respond to the higher costs of capital by dropping clients whose trades would have the largest impacts on the revised Complexity and Interconnectedness indicators – those that trade large notional values of OTC derivatives or are “financial institutions” under the capital rules. End users such as pension funds, insurance companies, and businesses across a wide variety of industries that rely on derivatives for risk management purposes, including agricultural businesses and manufacturers, may be affected disproportionately.

The Proposals may also incentivize some U.S. G-SIBs to raise prices for their clearing services, perhaps beyond the point where many clients would find it economical to use cleared OTC derivatives to hedge their risks. As an example of the potential impact, if a firm is required to maintain an additional \$1 billion in capital to continue to engage in OTC client clearing activities under the Proposals, the client clearing business would be required to increase its annual post-tax net income from OTC clearing by \$100 to \$150 million in order to meet an annual return on capital target of 10 to 15 percent. To the extent firms sought to make up those additional returns solely or partially through fee increases, clients might not willingly absorb such cost increases and continue to use OTC derivatives to hedge their risks. Moreover, it is not realistic to expect that clients would ever become direct members of a CCP, as the vast majority of clients are not financial institutions and thus are not equipped to manage the risks of being a clearing member, contribute to a CCP’s default fund, or comply with all the rules and requirements that apply to clearing members. If clients reduced their usage of OTC derivatives to hedge their risks, such a result would increase risk in the financial system and the real economy.

CFTC data show that U.S. G-SIBs currently perform 84 percent of all clearing activity in the United States.⁴¹ The top six FCMs that clear swaps are U.S. G-SIBs.⁴² These figures suggest that other clearing members will not be able or willing to make up for the loss in capacity if U.S. G-SIBs exit or scale back their clearing businesses.

2. Systemic Risk Could Increase Because of Barriers to Porting in Times of Stress

The Proposals create doubt about the viability of client porting if a major clearing member were to fail, because they would significantly increase the capital required for another

⁴¹ See Commodity Futures Trading Commission, Financial Data for FCMs, *available at* <https://www.cftc.gov/MarketReports/financialfcmdata/index.htm>.

⁴² See Commodity Futures Trading Commission, Financial Data for FCMs, *available at* <https://www.cftc.gov/MarketReports/financialfcmdata/index.htm>; see also Figure 4, above. These figures are based on the amount of customer funds held in FCM accounts.

banking organization clearing member to take on a substantial book of new business.⁴³ It is not certain that a U.S. G-SIB would be willing to allocate the substantial capital that would be required under the Surcharge Proposal and Endgame Proposal to take on the failed clearing member's clients. The Derivatives Assessment Team of the Financial Stability Board and other international standard-setting bodies ("DAT") has warned that if capital requirements for clearing are disproportionately high, "other providers may be unwilling to take on additional business, leaving some of the affected clients without access to OTC derivatives clearing."⁴⁴

Reductions in clearing member capacity "could amplify the consequences of the failure or withdrawal of a major provider" because there are fewer remaining clearing members that might be available and willing to step in and accept a portfolio of client derivatives.⁴⁵ These issues will be exacerbated in times of market stress. As the DAT explained, "a clearing service provider must have sufficient 'head room' in its regulatory metrics before accepting [clients that wish to port in], and additional client clearing business must offer an acceptable return on the required capital thus deployed."⁴⁶ Ad hoc capital relief provided by supervisors once the stress materialized would be insufficient to mitigate the risk of accepting business generating negative post-capital returns over the life of the trade. And ad hoc relief would also be insufficient because porting is only effective when it occurs rapidly.⁴⁷

F. Raising capital requirements for OTC derivatives clearing would contravene global and U.S. policies in favor of clearing

Imposing additional capital requirements on OTC derivatives clearing activities is inconsistent with the Pittsburgh G20 commitments of 2009 and the policy goals articulated by Chair Powell. Global regulators have cited central clearing as a key element to financial reform because it greatly reduces risk in the system. The G20 commitments establish a clear policy that mandatory clearing of certain derivatives is essential to improving risk management and

⁴³ Clearing members absorbed Credit Suisse's U.S. cleared derivatives client portfolio after that firm announced its exit from the U.S. market for clearing in November 2021. However, this exit may not be predictive of whether clearing members will have the capacity to port in a defaulting clearing member's business rapidly during times of stress if the Proposals are finalized as proposed and clearing members would incur a more significant capital penalty for absorbing others' client positions.

⁴⁴ DAT Report at p. 54.

⁴⁵ DAT Report at p. 3.

⁴⁶ DAT Report at p. 67.

⁴⁷ Besides porting, there are additional benefits to ensuring that clearing members have adequate capacity to take on new business. When there is capacity in the market, clients can diversify the number of providers they use, and market participants can choose to clear additional products that are not currently subject to a clearing mandate.

promoting financial stability. Among other elements of this policy, the G20 commitments endorse lower capital requirements for cleared derivatives.⁴⁸

Consistent with the G20 commitments, the Board should retain lower capital requirements for cleared derivatives compared to bilateral derivatives by maintaining the current exclusions for OTC derivatives clearing under the agency model from the Complexity and Interconnectedness indicators in the G-SIB Surcharge.

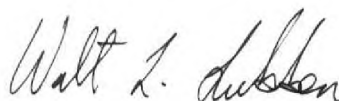
III. Conclusion

We urge the Board not to finalize its proposal to add OTC derivatives clearing activity under the agency model to the Complexity and Interconnectedness indicators of the G-SIB Surcharge. Such additions would be unnecessary, inconsistent with the Board's policies and principles, and harmful to end users, and would increase rather than decrease systemic risk.

* * *

We look forward to engaging with the Board on the matters discussed in this letter. If you have any questions, please contact Jacqueline Mesa, Chief Operating Officer and Senior Vice President of Global Policy at FIA at 202-466-5460.

Respectfully Submitted,



Walt L. Lukken
President and Chief Executive Officer
Futures Industry Association

⁴⁸ The G20 commitments provide that “[n]on-centrally cleared contracts should be subject to higher capital requirements,” implying that centrally cleared derivatives contracts should be subject to *lower* capital requirements. See Leaders’ Statement, The Pittsburgh Summit, September 24-25 2009, available at <https://www.oecd.org/g20/summits/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf>.

Appendix – Answers to Questions in Surcharge Proposal Preamble

Question 12: What are the advantages and disadvantages of including in the interconnectedness and complexity indicators guarantees of client performance to a CCP with respect to client cleared derivative positions?

Including guarantees of client performance to a CCP in a cleared OTC derivative transaction in the Interconnectedness and Complexity indicators would significantly and unnecessarily increase capital requirements associated with client clearing activities. Such higher capital requirements would have several disadvantages, including that clients would face barriers to accessing cleared OTC derivatives and that systemic risk could increase because of barriers to “porting” client portfolios in times of stress. See section II.E, above, for a more detailed discussion of these disadvantages.

Question 14: What are the advantages and disadvantages of the proposed revisions to the interconnectedness and complexity categories? What other changes should the Board consider, and why?

Please see our answer to question 12 and section II.E, above, for a discussion of the disadvantages of the proposed revisions to the Interconnectedness and Complexity categories.

COVINGTON