**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: Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)**

No. R-1814, RIN 7100-AG65

Dear Secretary Misback,

The International Swaps and Derivatives Association, Inc. ("**ISDA**") and the Securities Industry and Financial Markets Association ("**SIFMA**" and, together with ISDA, the "**Associations**") welcome the opportunity to comment on the proposal referenced above (the "**GSIB Surcharge NPR**") issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**").[1]

**Executive Summary**

This letter addresses only issues under the GSIB Surcharge NPR that are most directly relevant to derivatives. In that regard, the Associations offer three specific recommendations, the first of which relates to client-cleared derivatives specifically and the latter two of which relate to derivatives in general:

1. Client-cleared derivatives cleared under the agency model should not be included in the complexity and interconnectedness categories of the GSIB surcharge calculation.

2. Derivatives exposures should not be included in the cross-jurisdictional activity indicators. At a minimum, derivatives exposures should be net of collateral in the cross-jurisdictional activity indicators.

3. The SA-CCR alpha factor should not be included in the interconnectedness indicators calculations.

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[1] Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y–15), 88 Fed. Reg. 60,385 (Sept. 1, 2023).

**Client-cleared derivatives under the agency model should not be included in the complexity and interconnectedness categories of the GSIB surcharge calculation.**

We are concerned that the proposed inclusion of a banking organization's guarantees of client performance to a central counterparty ("**CCP**") with respect to client-cleared derivatives in the complexity and interconnectedness categories would (i) not align with the actual risk presented by this activity, (ii) sharply depart from the existing framework without sufficient explanation, (iii) reduce capacity and willingness of banking organizations to clear for clients, and (iv) contravene the long-standing public policy objective to promote central clearing. For these reasons, we urge the Federal Reserve not to adopt this aspect of the GSIB Surcharge NPR.

We strongly support the development of risk-sensitive capital requirements that are aligned with the economics of banking organizations' exposures and activities. The proposed change to the treatment of a banking organization's guarantees of client performance to a CCP with respect to client-cleared derivatives would frustrate this objective by further increasing capital requirements associated with client clearing, the risks of which are already over-capitalized in the U.S. regulatory capital framework. Client clearing is a low-risk activity that promotes financial stability and reduces the complexity of the financial system and individual banking organizations. In this regard, we share Chair Powell's view that regulators "have a responsibility to ensure that bank capital standards and other policies do not unnecessarily discourage central clearing."[2] We also share Governor Bowman's concern that an improperly calibrated capital requirement under the GSIB surcharge framework "may discourage low-risk activities or result in unintended consequences."[3]

In addition to our specific concerns about the GSIB Surcharge NPR's treatment of banking organizations' guarantees of client performance to a CCP with respect to client-cleared derivatives, we are more generally concerned about the impact of higher capital requirements on the ability of banking organizations to intermediate client clearing. Higher capital requirements under the GSIB Surcharge NPR and the U.S. banking agencies' Basel III Endgame proposal[4] would further constrain large banking organizations' balance sheet capacity available for a range of activities, potentially including client clearing. Insufficient access to client clearing could be detrimental to market structure and financial stability, particularly in times of volatility and market stress. We urge the Federal Reserve to consider the aggregate impact of its proposed regulatory capital-related rules on the provision of critical financial services, including client

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2 Federal Reserve Governor Jerome H. Powell, Central Clearing and Liquidity, Federal Reserve Bank of Chicago Symposium on Central Clearing, Chicago, Illinois (June 23, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/files/powell20170623a.pdf.

3 Statement by Governor Michelle W. Bowman (July 27, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm.

4 Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64,028, 64,170-71 (Sept. 18, 2023).

clearing, and consult with the Securities and Exchange Commission ("**SEC**")[5] and the Commodity Futures Trading Commission ("**CFTC**") on the interaction of its proposals with other regulatory mandates in critical markets.

According to the Associations' quantitative impact study ("**QIS**"), in which all six GSIBs that provide clearing services in the United States participated, including derivatives notional exposures cleared under the agency model in the complexity indicator (+69.4 points) and the interconnectedness indicators (+4.5 points), would in aggregate increase the GSIB score of the six participating banking organizations by 74 points.[6] This increase in method 2 surcharge scores would be applied to risk-weighted assets ("**RWAs**") calculated under the proposed expanded risk-based approach and therefore would significantly raise capital requirements, by $5.2 billion,[7] in the aggregate across all QIS participants. The effect of the proposed changes to the GSIB methodology cited above would be compounded by the significant impact of the higher RWA requirements under the U.S. Basel III Endgame proposal.

As this cost would be driven solely by GSIBs' clearing businesses, there could be pressure on these businesses to reduce the notional amounts stemming from client clearing, especially if the marginal impact of clearing activity is to push a GSIB into the next GSIB surcharge bucket.

Part I of this letter discusses in greater detail why the Federal Reserve should retain the existing treatment of client-cleared derivatives under the GSIB surcharge framework.

**Derivatives exposures should not be included in cross-jurisdictional activity indicators. At a minimum, derivatives exposures should be net of collateral in the cross-jurisdictional activity indicators.**

It is unclear why the cross-jurisdictional activity indicators should include derivatives exposures (both client-cleared and otherwise), especially as these exposures are already captured in other indicators, including in the size, interconnectedness and complexity categories. By the Federal Reserve's own analysis, the inclusion of derivatives exposures is one of the main drivers of the

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5 Market participants are still analyzing the impact of the SEC's recently finalized clearing requirements for U.S. Treasury security transactions. However, if clearing capacity is already constrained, it could be challenging to add a new asset class (U.S. Treasuries and repos) to the set of products that clients are required to clear.

6 Other proposed changes would reduce the impact of the GSIB Surcharge NPR: Expanding the FI definition and the implementation of SA-CCR would reduce the impact by 7 points to a total increase of 67 points. This reduction is largely driven by SA-CCR implementation and could be less if, for example, the SA-CCR alpha factor were applied (see section II.B). In addition, the analysis excludes the impact of averaging, which the Federal Reserve estimates would raise method 2 GSIB scores by 9 points on average. *See* 88 Fed. Reg. at 60,397.

7 The total impact was calculated based on the total increase of the GSIB score for each firm, multiplied by the estimated Basel III expanded risk-based approach RWAs for each firm.

increase in method 2 scores as a result of the GSIB Surcharge NPR.[8] We urge the Federal Reserve not to include derivatives exposures in the cross-jurisdictional activity indicators. At a minimum, banking organizations should be permitted to calculate derivatives exposures included in cross-jurisdictional claims and cross-jurisdictional liabilities net of collateral.

**The SA-CCR alpha factor should not be included in the interconnectedness indicators calculations.**

As stated in the preamble to the SA-CCR final rule, the alpha factor is "designed to address risks that are not directly captured under SA-CCR, and to ensure that the capital requirement for a derivative contract under SA-CCR is generally not lower than the one produced under IMM".[9] The "risks not directly captured" relate in particular to wrong-way risk.[10] This risk adjustment is inappropriate in the context of an exposure metric to measure interconnectedness as opposed to a measure of risk as applicable in risk-weighted assets. An exposure metric to measure interconnectedness should not include unrelated multipliers. In addition, the second objective mentioned above does also not justify the inclusion of the alpha multiplier. In particular, the U.S. banking agencies' Basel III Endgame proposal generally prohibits the use of internal models. Even without considering the elimination of the internal models methodology ("**IMM**") from the RWA framework, the calibration comparability to IMM is simply not relevant in the context of the GSIB surcharge. Therefore, the Federal Reserve should not include the alpha factor in the calculation of derivatives exposures for the interconnectedness indicators.

Part II of this letter discusses in greater detail why our recommendations would improve the calibration and coherence of the GSIB surcharge framework.

## I The existing treatment of client-cleared derivatives under the GSIB surcharge framework aligns with the actual risk presented by this activity and long-standing public policy objectives.

Following the commitment by the G20 Leaders in 2009 that standardized over-the-counter ("**OTC**") derivatives should be cleared through CCPs,[11] the Federal Reserve and other U.S. and global regulators have consistently recognized the risk-reducing nature of central clearing.[12] As

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8 88 Fed. Reg. 60,397.

9 Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, 85 Fed. Reg. 4,362, 4,366 (Jan. 24, 2020).

10 *See* 85 Fed. Reg. 4,372 ("Additionally, the alpha factor serves to capture certain risks (*e.g.*, wrong-way risk, non-granular risk exposures, etc.) that are not fully reflected under either IMM or SA-CCR.").

11 *See* G20, Leaders' Statement (Sept. 24-25, 2009), *available at* https://www.oecd.org/g20/summits/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf.

12 *See, e.g.*, Federal Reserve Vice Chair Janet L. Yellen, Interconnectedness and Systemic Risk: Lessons from the Financial Crisis and Policy Implications, Speech at the American Economic Association/American

the GSIB Surcharge NPR recognizes, banking organizations use two structures to act as a clearing intermediary for clients: (i) the principal model, under which the banking organization facilitates clearing by becoming a direct counterparty to both the client and the CCP, and (ii) the agency model, under which the banking organization guarantees the client's performance to the CCP (but not the CCP's performance to the client).[13] Both models present low levels of risk to the banking organization and significantly mitigate risk to the financial system, as further explained below. Moreover, the capital requirements that already apply to client clearing are more than sufficient to address the associated risks.

The GSIB Surcharge NPR would include a banking organization's guarantees of client performance to a CCP with respect to client-cleared derivatives in the calculation of three indicators—(i) notional amount of OTC derivatives in the complexity category, (ii) intra-financial system assets in the interconnectedness category, and (iii) intra-financial system liabilities in the interconnectedness category.[14] This change, which would increase capital requirements for GSIBs due to their provision of clearing services, would not align with the actual risk presented, the complexity category under the international standard,[15] or the long-standing public policy objective of encouraging greater central clearing. In addition, this change would represent a sharp departure from the well-functioning framework currently in place without sufficient analysis or justification. Finally, guarantees of client performance to a CCP with respect to client-cleared derivatives are already captured by the size category.[16]

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Finance Association Joint Luncheon, San Diego, California (Jan. 4, 2013), *available at* https://www.federalreserve.gov/newsevents/speech/Yellen20130104a.pdf ("Central clearing can yield important advantages over a fully bilateral market structure. The simpler hub-and-spoke network structure is more transparent, and the central counterparty is well positioned to impose common margin requirements on all market participants. Central clearing facilitates the netting of gains and losses across multiple market participants, which has the potential to significantly reduce each participant's aggregate counterparty risk exposure.").

13 *See* 88 Fed. Reg. at 60,392.

14 *See id.*

15 *See* Basel Committee on Banking Supervision, *Instructions for the end-2022 G-SIB assessment exercise* 24 (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.").

16 *See* Instructions for the Preparation of Systemic Risk Report, Reporting Form FR Y-15, at A-1 (Sept. 2021), *available at* https://www.federalreserve.gov/apps/reportingforms/Download/DownloadAttachment?guid=ba9b1d68-3a2a-4472-84e6-0130d5c8a601 ("Where a clearing member banking organization guarantees the performance of a client to a CCP (and would thus have a payment obligation to the CCP in the event of a client default) (*i.e.*, the *agency model*), the clearing member banking organization must treat the exposure associated with the guarantee as a derivative contract and report the associated current exposure.").

**A. Banking organizations' guarantees of client performance to a CCP with respect to client-cleared derivatives should not be included in either the complexity or interconnectedness category because client-cleared derivatives present low levels of risk to individual banking organizations and reduce systemic risk.**

Central clearing of derivative products reduces systemic risk through multilateral netting, standardization, and enhanced market transparency in comparison to purely bilateral OTC derivatives. CCPs also help to reduce the complexity and interconnectedness of banking organizations through the reduction of bilateral counterparty relationships and the use of default management processes implemented by regulated CCPs, including waterfall arrangements (such as initial and variation margin, pre-funded default fund contributions, and CCP capital) that reduce the likelihood that the default of one clearing member would result in losses to other clearing members and the financial system.[17] Moreover, economists at the Office of Financial Research and the Office of the Comptroller of the Currency have recently observed the "historical rarity of CCP member defaults," underscoring the risk-reducing nature of this activity.[18] Contrary to the risk-reducing nature of client-cleared derivatives, the GSIB Surcharge NPR would—without explanation or supporting data—treat client-cleared derivatives as posing equal risk as bilateral OTC derivatives. We would also note that a key driver for the clearing mandate of Treasury securities was the reduction of systemic risk.[19]

In the event of a defaulted clearing member, a CCP "must promptly port or liquidate the client accounts,"[20] which also reduces systemic risk.[21] However, the GSIB Surcharge NPR would render the porting of positions following a clearing member default event more challenging, as the GSIB surcharge framework would constrain clearing capacity at alternative clearing

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17 *See* Froukelien Wendt, *Central Counterparties: Addressing their Too Important to Fail Nature*, IMF Working Paper (Jan. 27, 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.").

18 Mark Paddrik and Simpson Zhang, *Central Counterparty Default Waterfalls and Systemic Loss* (June 18, 2020), *available at* https://www.financialresearch.gov/working-papers/files/OFRwp-20-04_central-counterparty-default-waterfalls-and-systemic-loss.pdf.

19 Gary Gensler, SEC Chair, *Statement on Final Rules Regarding Treasury Clearing* (Dec. 13, 2023), *available at* https://www.sec.gov/news/statement/gensler-statement-treasury-clearing-121323.

20 Committee on Payments and Market Infrastructures, *Client clearing: access and portability* 16 (Sept. 2022), *available at* https://www.bis.org/cpmi/publ/d210.pdf.

21 *See id.* at 17 ("Putting in place effective practices to facilitate porting therefore reduces the costs and potential market disruption associated with closing positions, preserves clients' access to central clearing, and reinforces the value of clearing for clients.").

intermediaries, since the incremental capital requirement from receiving the accounts is a key consideration for a receiving clearing intermediary.[22]

Due to the risk-reducing nature of client clearing, it would not be appropriate to include the client-facing leg of a cleared derivative under the agency model in the complexity or interconnectedness category. Client-cleared derivatives under the agency model present low levels of risk to clearing members because clients are required to post initial margin to guard against movements in market prices based on historical volatility and variation margin—on at least a daily basis—based on the mark-to-market value of the position.[23] Accordingly, a banking organization acting as an intermediary would incur losses only in the unlikely event that the client defaults *and* the price movement of the position in less than one day exceeded the initial and variation margin posted by the client.[24]

The proposed inclusion of the client-facing leg of a cleared derivative under the agency model in the complexity or interconnectedness category would result in a significant increase in capital requirements for providing clearing services to customers. In addition to imposing a capital requirement that is not commensurate with the risk to a banking organization acting as a clearing member, the proposed change could have the perverse impact of *increasing* systemic risk by further reducing the availability of client-cleared derivatives. The number of institutions providing client clearing services has greatly diminished in recent years. Capital requirements for these firms—many of which are U.S. banking organizations and, more specifically, U.S. GSIBs—have been a major driver of this decrease. As part of its 2018 analysis of incentives to centrally clear OTC derivatives, the Derivatives Assessment Team convened by the Financial Stability Board and other standard-setting bodies noted that the GSIB surcharge framework was "identified by client clearing service providers in the qualitative surveys as the second most commonly cited disincentive to clear or provide client clearing services," with 44% of client clearing service providers stating that it was a disincentive to clear.[25] The proposed change to the treatment of a banking organization's guarantees of client performance to a CCP with respect

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22 *See* ISDA Whitepaper, *Addressing porting challenges* (October 2023), *available at* https://www.isda.org/a/dq7gE/Addressing-Porting-Challenges.pdf.

23 *See* 17 C.F.R. § 39.13(g) (prescribing margin requirements for derivatives clearing organizations, including the types of assets accepted as initial margin); *see also* 17 C.F.R. § 1.25 (restricting investment of customer funds by futures commission merchants and derivatives clearing organizations).

24 Under the rulebooks of some CCPs, variation margin is considered a settlement payment with title transferring to the receiving party rather than as collateral with title remaining with the posting party. *See, e.g.*, OCC, Federal Reserve, FDIC, Regulatory Capital Treatment of Certain Centrally-cleared Derivative Contracts Under Regulatory Capital Rules (Aug. 14, 2017), *available at* https://www.federalreserve.gov/supervisionreg/srletters/sr1707a1.pdf.

25 *Incentives to centrally clear over-the-counter (OTC) derivatives* 69 (Nov. 19, 2018), *available at* https://www.fsb.org/wp-content/uploads/R191118-1-1.pdf ("**Incentives to Clear Report**"). The leverage ratio was the most commonly cited disincentive to clear or provide client clearing services, with 72% of client clearing service providers stating that it was a disincentive to clear.

to client-cleared derivatives would only further disincentivize central clearing, which could reduce the number of firms providing these services, increase concentration, make it more difficult to port client positions in the event of a defaulted clearing member, and result in higher costs for commercial end-users. On both an individual and collective basis, these impacts would undermine the benefits of central clearing and increase risk across the financial system.

Accordingly, it would not be appropriate to include the client-facing leg of a cleared derivative under the agency model in either the complexity or interconnectedness category.

### B. The proposed change to the treatment of client-cleared derivatives would depart sharply from the well-functioning framework currently in place without sufficient explanation.

Since the finalization of the GSIB surcharge framework in the United States in 2015, the complexity and interconnectedness categories have excluded transactions in which a banking organization, acting as agent for a client's OTC derivative trade, guarantees the client's performance to a CCP (but not the CCP's performance to the client).[26] These exclusions appropriately align the GSIB surcharge framework with the actual risk presented by this activity and recognize that central clearing of OTC derivatives decreases the complexity and interconnectedness of banking organizations.

The inclusion of a banking organization's guarantees of client performance to a CCP with respect to client-cleared derivatives under the complexity and interconnectedness categories would be a major policy shift from the existing GSIB surcharge framework, but the GSIB Surcharge NPR offers virtually no details or explanation for this proposed change. Indeed, the sole justification appears to be to "promote consistent treatment of the two clearing models and better capture sources of interconnectedness and complexity."[27] Yet, the GSIB Surcharge NPR does not provide any historical evidence, data, or support for the broad assertion that this change would better capture sources of complexity or interconnectedness.

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26 *See* Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49,082 (Aug. 14, 2015); *see also* Instructions for the Preparation of Systemic Risk Report, Reporting Form FR Y-15 (Sept. 2021), *available at* https://www.federalreserve.gov/apps/reportingforms/Download/DownloadAttachment?guid=ba9b1d68-3a2a-4472-84e6-0130d5c8a601 (instructing banking organizations not to include client-cleared derivatives for purposes of the interconnectedness or complexity categories where the bank is not a direct counterparty to the CCP unless the banking organization guarantees the CCP's performance to the client).

27 88 Fed. Reg. 60,392. With respect to interconnectedness, the GSIB Surcharge NPR argues that client-cleared derivatives "could become transmission channels for distress if the banking organization experienced material distress or failure." *Id.* With respect to complexity, the GSIB Surcharge NPR argues that OTC derivatives "contribute to complexity, whether the banking organization is a primary or secondary obligor." *Id.*

Moreover, the Federal Reserve recently proposed—*and explicitly rejected*—substantively identical changes to the GSIB surcharge framework.[28] With respect to the complexity category, the Federal Reserve stated that it "does not believe it is appropriate at this time to treat the client leg of a cleared transaction in the agency model as more complex than a simple credit exposure."[29] The Federal Reserve noted that "part of the motivation for including the client leg of the agency model was to make sure that . . . no one model [of clearing] receives significantly more or less representation with respect to the GSIB indicators," but concluded that 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."[30] With respect to the interconnectedness category, the Federal Reserve similarly opted not to adopt the proposed change after considering comments from the public.[31] The nature of the OTC derivatives clearing market has not changed in the intervening years, and it is unclear on what basis the Federal Reserve believes it is necessary to reverse course to adopt the changes that it previously proposed, on which it received extensive public comment, and that it ultimately rejected. The lack of evidence, data, or support for the proposed change—both in the original 2017 proposal and in the GSIB Surcharge NPR—makes it especially difficult to reconcile these divergent positions.

### C. The proposed change to the treatment of client-cleared derivatives would contravene the long-standing public policy objective to promote central clearing.

Finally, the proposed change would directly contravene the long-standing public policy objective to promote central clearing. Central clearing was a key component of both the Dodd-Frank Act[32] and the international response to the financial crisis.[33] A significant proportion of OTC derivatives are now centrally cleared through regulated CCPs, and many derivatives trade on

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28 Agency Information Collection Activities: Announcement of Board Approval Under Delegated Authority and Submission to OMB, 83 Fed. Reg. 31,144 (July 3, 2018).

29 *Id.* at 31,145.

30 *Id.* Because the treatment of client-cleared derivatives under the principal model and the agency model is the same for all GSIBs, the Federal Reserve stated that it was "not currently concerned that excluding the client leg from the GSIB indicators will result in a significant disparity among reporters." *Id.*

31 *See id.* at 31,146.

32 *See, e.g.*, U.S. Department of the Treasury, "The Dodd-Frank Act" (Jan. 2017), *available at* https://obamawhitehouse.archives.gov/sites/whitehouse.gov/files/images/Blog/Wall%20Street%20Reform%20Deck%20--%20January%202017.pdf ("Standardized derivatives are required to be centrally cleared and traded on exchanges or transparent trading platforms, with appropriate margining, increasing transparency and reducing risk.").

33 *See* G20 *supra*, note 11.

regulated venues, such as swap execution facilities ("**SEFs**").[34] The commitment to increasing central clearing is predicated on the availability of clearing members to provide clients with access to CCPs. By disincentivizing central clearing, increasing concentration in this market, and raising costs for commercial end users, the GSIB Surcharge NPR would stand in direct conflict with international public policy commitments—an incongruity that the GSIB Surcharge NPR never addresses.

### D. Results of the Associations' QIS.

According to our QIS, in which all six GSIBs that provide clearing services in the United States participated, including derivatives notional exposures cleared under the agency model in the complexity indicator (+69.4 points) and the interconnectedness indicators (+4.5 points), would in aggregate increase the GSIB score of the six participating banking organizations by 74 points.[35] We believe that the QIS participants estimated their impact conservatively, as feedback from CCPs points to an even higher impact of including derivatives notional exposures cleared under the agency model in the complexity indicator.

The Associations stress that this impact is higher than the two items that the Federal Reserve notes as the main drivers of the approximately 27 point increase estimated on average across firms, *i.e.*, addition of cross-jurisdictional derivative exposures (+11 points) and the averaging of indicators (+9 points).[36] Given the lack of explicit reference to the impact on clearing as part of the cost analysis by the Federal Reserve, the Associations are concerned that this impact has not been fully understood.

While this may result in an increase in method 2 surcharge of "only" 7.5 basis points on average,[37] the Associations emphasize that the GSIB surcharge change for client clearing would be applied to total expanded risk-based approach RWAs and therefore would significantly raise capital requirements by $5.2 billion in aggregate across all QIS participants. This would be a

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34 *See* ISDA, *SwapsInfo First Half of 2023 and the Second Quarter of 2023 Review: Summary* (July 2023), *available at* https://www.isda.org/a/8NogE/SwapsInfo-First-Half-of-2023-and-Second-Quarter-of-2023-Review-Summary.pdf (noting that Cleared IRD transactions accounted for 78.4% of total traded notional and 79.4% of trade count. 87.2% of fixed for-floating IRS, 97.7% of FRA, 86.4% of OIS and 12.4% of other IRD traded notional was cleared; and SEF-traded interest rate derivatives comprised 52.5% of total traded notional and 65.8% of trade count in the first half of 2023).

35 Other proposed changes would reduce the impact of the GSIB Surcharge NPR: Expanding the FI definition and the implementation of SA-CCR would reduce the impact by 7 points to a total increase of 67 points. This reduction is largely driven by SA-CCR implementation and could be less if, for example, the SA-CCR alpha factor were applied (see section II.B). In addition, this analysis excludes the impact of averaging, which the Federal Reserve estimates would raise method 2 GSIB scores by 9 points on average. *See* 88 Fed. Reg. at 60,397.

36 *See* 88 Fed. Reg. at 60,397.

37 The average is reported across the 5 GSIBs that reported an impact.

substantial increase in the relative GSIB surcharge footprint of client clearing services across GSIBs.

The effect of the proposed changes to the GSIB methodology cited above would be compounded by the impact of the higher RWAs under the U.S. Basel III endgame proposal. In combination, the total increase in capital requirements attributable to client-clearing businesses under the two proposals is estimated at $7.2 billion (including the $5.2 billion cited above), or an 80% increase relative to today's requirements.[38]

As this cost would be driven solely by GSIBs' clearing businesses, there could be pressure on these businesses to reduce the notional amounts stemming from client clearing, especially if the marginal impact of clearing activity is to push a GSIB into the next GSIB surcharge bucket.

Assuming an expected return on equity target of 10% to 15%,[39] the additional return[40] required from clearing businesses to cover the 5.2 billion increase in capital requirements would be between $520 million and $780 million in aggregate. This could be passed on to clients or result in the GSIB being more selective in the provision of client-clearing services, running counter to the public policy goal of encouraging greater use of central clearing. The Incentives to Clear Report of the Derivatives Assessment Team states: "Despite this optimisation to meet business goals, some providers report that client clearing service provision still does not meet internal return on equity targets. This is likely to be an important factor causing some firms to withdraw or to reduce their offering of client clearing services."[41] Increasing capital requirements through both higher RWAs and increases in the GSIB surcharge would introduce further challenges for these businesses to meet return on equity targets and discourage the long-term investment levels necessary to sustain the service.

We also note that clearing OTC derivatives for clients under the agency model makes up only a part of a derivatives clearing business, with the other part being clearing of futures and options.

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38 The Associations are also submitting a comment letter to the FDIC, Federal Reserve and OCC on the U.S. Basel III endgame proposal. That letter focuses on issues arising from the Fundamental Review of the Trading Book/market risk and credit valuation adjustment risk aspects of that proposal, as well as, with respect to counterparty credit risk, aspects of that proposal relating to securities financing transactions and derivatives. Section VIII of that letter provides recommendations regarding the effect of that proposal on clearing businesses and quantifies the impact of the proposal as well certain recommendations relating to clearing.

39 This range is not based on QIS results and is presented purely for illustrative purposes.

40 Based on net income, not revenue.

41 Incentives to Clear Report, *supra*, note 25, at 52.

In aggregate, clearing of OTC derivatives is smaller than clearing of futures and options in terms of initial margin.[42]

## II The Federal Reserve should make additional changes to the GSIB Surcharge NPR to improve the calibration and coherence of the GSIB surcharge framework.

In addition to retaining the existing treatment of client-cleared derivatives, the Federal Reserve should make additional changes to the GSIB Surcharge NPR to improve the calibration and coherence of the overall framework.

### A. Cross-jurisdictional activity indicators should not include derivatives exposures. At a minimum, derivatives exposures should be net of collateral in the cross-jurisdictional activity indicators.

The GSIB Surcharge NPR would revise the systemic indicators for cross-jurisdictional claims and cross-jurisdictional liabilities to include derivatives exposures, which generally would be calculated gross of collateral.[43] This revision is unnecessary, as a banking organization's derivatives exposures are already captured through other systemic indicators, including in the size, interconnectedness and complexity categories. The GSIB Surcharge NPR does not adequately justify why it is necessary to add these exposures to additional indicators, otherwise explain how the existing GSIB surcharge framework is not adequate to capture a banking organization's systemic risk, or provide explanation or data to support the notion that the current framework "present[s] opportunities for a banking organization to use derivatives to structure its

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42 Based on data published by the CFTC as of October 31, 2023 (available at https://www.cftc.gov/MarketReports/financialfcmdata/index.htm), in aggregate and measured by initial margin, the OTC business covers 41% of the U.S. GSIB's derivatives clearing businesses ($127.86 billion out of a total of $310.64 billion):

| **Futures Commission Merchant / Retail Foreign Exchange Dealer** | **Futures and Options** | | **OTC Derivatives** |
|---|---|---|---|
| | Customers' Seg Required 4d(a)(2) | Customer Amount Pt. 30 Required | Customer Amount Cleared Swap Seg Required |
| BofA Securities Inc. | $26.56 billion | $4.42 billion | $16.46 billion |
| Citigroup Global Markets Inc. | $16.30 billion | $3.86 billion | $32.40 billion |
| Goldman Sachs & Co. LLC | $35.58 billion | $9.72 billion | $18.62 billion |
| JP Morgan Securities LLC | $38.57 billion | $6.15 billion | $20.48 billion |
| Morgan Stanley & Co. LLC | $26.83 billion | $8.40 billion | $26.17 billion |
| Wells Fargo Securities LLC | $5.99 billion | $0.38 billion | $13.72 billion |
| **Total** | **$149.82 billion** | **$32.94 billion** | **$127.86 billion** |

43 88 Fed. Reg. 60,394.

exposures in a manner that reduces the value of its systemic indicators without reducing the risks the indicator is intended to measure."[44] Therefore, we urge the Federal Reserve not to include such exposures in additional indicators in the final rule.

At a minimum, a banking organization should be permitted to calculate derivatives exposures included in cross-jurisdictional claims and cross-jurisdictional liabilities net of collateral. This approach would align with the calculation of other systemic indicators and appropriately reflect the actual risk of the banking organization's derivatives exposures. Not recognizing collateral would result in divergence between the calculation of systemic indicators and the long-standing agency understanding of the risk-mitigating benefits of collateral.

### B. The SA-CCR alpha factor should not be included in the interconnectedness indicators calculations.

The GSIB Surcharge NPR would incorporate SA-CCR to measure derivatives exposures for purposes of the interconnectedness indicators.[45] The manner in which the SA-CCR alpha multiplier and potential future exposure multiplier would be reflected in the replacement cost and potential future exposure calculations for purposes of the interconnectedness indicators is not clear.

The alpha factor should not be included in the exposure calculation used for purposes of the interconnectedness indicators. The interconnectedness indicator is designed to measure the degree to which a banking organization is interconnected with other financial institutions.[46] The alpha factor is designed to serve an entirely different and unrelated purpose in the bank capital framework, specifically, to be "a measure of conservatism that is designed to address risks that are not directly captured under SA-CCR, and to ensure that the capital requirement for a derivative contract under SA-CCR is generally not lower than the one produced under IMM."[47] As noted above, both the risks that are meant to be captured as well as the comparability to IMM are not relevant in the context of the interconnectedness indicators. Hence, including the alpha factor for purposes of the interconnectedness indicators would overstate the extent of a banking organization's transactions with other financial institutions and detract from the coherence of the GSIB surcharge framework.

## Conclusion

The Associations appreciate the opportunity to submit our comments on the GSIB Surcharge NPR. We are strongly committed to maintaining the safety and efficiency of U.S. financial markets and hope the Federal Reserve implements our recommendations, which reflect the

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44 *Id.*

45 *See* 88 Fed. Reg. 60,392.

46 *See* 80 Fed. Reg. at 49,095.

47 85 Fed. Reg. at 4,366.

extensive knowledge and experience of market professionals within the Associations and our members. Our recommendations are designed to make the U.S. capital framework more risk-sensitive and to avoid the potential adverse consequences of the GSIB Surcharge NPR on financial markets, consumers, end users, and the economy more generally. Please contact Ulrich Karl at ukarl@isda.org or +44 (0)20 3808 9700 and Guowei Zhang at gzhang@sifma.org or (202) 962-7340 if you wish to discuss the points raised in this letter further.

Very truly yours,

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## About the Associations

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on ISDA's website: www.isda.org.

SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).