sifma
asset management group

MANAGED FUNDS ASSOCIATION

October 20, 2017

By Email (regs.comments@federalreserve.gov)

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

**Re: Proposed Changes to G-SIB Surcharge Calculation (FR Y-15; OMB Control Number: 7100–0352)**

Dear Ms. Misback:

The Securities Industry and Financial Markets Association's Asset Management Group ("**AMG**") and Managed Funds Association ("**MFA**" and together with AMG, the "**Associations**")[1] appreciate the opportunity to comment on the proposal by the Board of Governors of the Federal Reserve System (the "**Board**") to amend the FR Y-15 reporting instructions for U.S. global systemically important banks ("**G-SIBs**").[2] The Proposal would penalize the clearing of client positions through a GSIB's futures commission merchant ("**FCM**") by disproportionately increasing the G-SIB Surcharge scores for this activity. The Associations urge the Board to withdraw the Proposal due to its inconsistency with regulatory directives to clear derivatives – directives that the Associations have supported as beneficial to market stability and management of counterparty risks – and the negative and unwarranted effects the Proposal would have on clients that use cleared derivatives.

The volume of cleared derivatives transactions executed by asset managers on behalf of their clients has dramatically increased due to regulatory directives to clear, making FCMs' willingness to clear an important linchpin to achieving the goals of regulatory reform.[3] Pension funds, retail investor funds (*e.g.*, U.S. mutual funds and UCITS), private funds and other investors for which asset managers serve as fiduciaries ("**clients**") have shifted a significant percentage of bilateral derivatives to central counterparties ("**CCPs**") after the financial crisis. Post-crisis regulations advanced this migration

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1 Descriptions of the Associations are set forth in the Appendix to this letter.

2 82 Fed. Reg. 40,154 (Aug. 24, 2017), referred to herein as the "**Proposal**."

3 *See, e.g.*, U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities, p. 9 (Oct. 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf ("Reforms in the derivatives market, such as mandatory central clearing of certain swaps and increased data disclosure requirements, have been effective in promoting greater market liquidity and transparency.").

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directly through mandating the clearing of additional derivatives pursuant to requirements put in place by Congress under Title VII of the Dodd-Frank Act, and indirectly through, for example, higher margin requirements for uncleared transactions. Asset managers' clients typically must transact through FCMs who, as members of the CCPs in the U.S., act as the clients' agents in handling the transactions. Under current processes in the U.S., FCMs typically guarantee the client's performance to the CCP because FCMs assess and manage clients' risk profiles while CCPs typically do not.[4] U.S. G-SIBs handle a substantial amount of the total clearing volume in the United States.

The migration of derivatives to central clearing decreases clients' counterparty risks to G-SIBs and reduces systemic risk overall. Clearing via CCPs with robust resiliency, recovery and resolution standards allows clients to reduce counterparty risks and transact in a more liquid and stable derivatives market. Clearing provides many benefits to the swaps market, including improved market liquidity and market integrity. For these and other reasons, the Associations have supported regulatory initiatives to require and foster clearing.

However, prudential requirements that inflate the economic risk of derivatives, particularly the Supplementary Leverage Ratio ("**SLR**"), impose artificial barriers for asset managers' clients to access cleared derivatives and work at cross-purposes with mandates to clear. Recognizing these effects, Board Governor Jerome H. Powell recently stated that "[g]lobal authorities . . . have a responsibility to ensure that bank capital standards and other policies do not unnecessarily discourage central clearing."[5] The Associations share Governor Powell's sentiments and believe the Proposal would directly contradict his clear mandate by newly imposing disproportionately high capital requirements for G-SIBs that, in acting as agents on behalf of clients, guarantee their clients' obligations to CCPs.

For the reasons discussed below, the G-SIB surcharge, as amended by the Proposal, would overstate the risk arising from an FCM's clearing of client positions and, as a direct consequence, discourage derivatives clearing. Accordingly, we request that the Board withdraw the Proposal. If the Board does not withdraw the Proposal, the Associations urge that, at a minimum, the Board provide an analysis of the Proposal's calibration of risk and the likely impacts of increasing the G-SIB Surcharge scores for derivatives clearing so that asset managers and their clients can understand and comment on the Board's reasoning for the change.

## I. The Proposal Overstates the Risk Arising from an FCM's Agency-Model Clearing Business

FCMs incur limited risk when guaranteeing clients' performance to a CCP in a cleared derivative transaction. When an FCM guarantees a client's performance to a CCP, the probability that the FCM will be required to step in and make a significant payment to the CCP is substantially mitigated by initial and variation margin posted by the client. The FCM is only economically "on the hook" to the extent the client defaults and the amount the client owes is not covered by its initial margin and variation margin, both of which are addressed daily by margin calls. Commodity Futures Trading Commission ("**CFTC**") regulations and CCP rules require the client to post an amount of

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4 In the U.S., FCMs typically do not guarantee the CCP's performance to the client.

5 Remarks by Governor Jerome H. Powell at the Federal Reserve Bank of Chicago Symposium on Central Clearing, Central Clearing and Liquidity, at p. 4 (June 23, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/files/powell20170623a.pdf.

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initial margin to cover the CCP's exposure with an established confidence level of 99 percent.[6] Additionally, CFTC regulations impose segregation requirements and limit the assets in which initial margin can be reinvested to low-risk, highly liquid securities,[7] which help ensure that the initial margin will be available to cover amounts due to the CCP.

The current G-SIB Surcharge ***already*** captures a G-SIB's limited risk from agency-model clearing by counting the potential future exposure associated with the guarantee of its client's performance to the CCP within the Size Indicator.[8] If anything, the Size Indicator actually ***overstates*** the actual economic exposure of a G-SIB in a cleared derivative transaction, because it uses the SLR methodology, which does not recognize the exposure-reducing effect of initial margin.[9]

While the Proposal would include a G-SIB's agency clearing business under both the Interconnectedness and Complexity Indicators in addition to its current inclusion under the Size Indicator, the G-SIB's exposure in a cleared derivative transaction is neither complex nor interconnected. To the contrary, the migration of derivatives to central clearing greatly reduces counterparty exposure and interconnectedness, and increases standardization and liquidity. Rather than a G-SIB having to offload the underlying market risk of a bilateral trade through an equal and offsetting derivative transaction with a third party institution, cleared derivative transactions are entered into with a single counterparty (the CCP), and the G-SIB as guarantor primarily takes on credit risk that is substantially mitigated by initial margin and variation margin.[10] Even though a G-SIB guarantees the client's performance to the CCP, it typically does not guarantee the CCP's performance to the client.

The existing measurement of an FCM's agency clearing business within the G-SIB Surcharge sufficiently captures any systemic risk, and the Proposal does not offer any evidence of uncaptured risks that must be addressed.[11] In light of the low-risk nature of derivatives clearing and the inclusion of client performance guarantees within the Size Indicator, we believe that increasing the G-SIB Surcharge by ***also*** including these guarantees in the Interconnectedness and Complexity Indicators would result in a significant overstatement of risk.

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6 *See* 17 C.F.R. § 39.13(g)(2)(iii).

7 17 C.F.R. §§ 1.20-1.30 (futures); 17 C.F.R. §§ 22.2- 22.7 (cleared swaps).

8 *See* Banking Organization Systemic Risk Report—FR Y-15, *available at* https://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYJ+5BzDaRHakir9P9vg==.

9 *See* SIFMA AMG Submits Comments to the Basel Committee on Banking Supervision on Higher Prices and Reduced Access to Clearing Experienced by Asset Managers, at p. 3 (Feb. 1, 2016), *available at* https://www.sifma.org/resources/submissions/sifma-amg-submits-comments-to-the-basel-committee-on-banking-supervision-on-higher-prices-and-reduced-access-to-clearing-experienced-by-asset-managers/.

10 While we do not address the different clearing model utilized in Europe, we believe the European model provides similar means of reducing interconnectedness and complexity.

11 We note that apart from systemic risk, the generally applicable regulatory capital rules already take into account the risk *to a G-SIB* arising out of its derivatives clearing activities.

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## II. The Proposal's Overstatement of Derivatives Clearing Risks Would Disproportionately Discourage Derivatives Clearing

The Associations believe that, by setting capital requirements at levels that overstate the risk, the Proposal would disincentivize G-SIBs from providing clearing services to their clients. We understand that banking organizations allocate capital to business lines based on expected returns. As such, an organization will use its balance sheet to fund businesses that can meet return-on-equity ("ROE") targets given the amount of capital required to be held against the activities of each business. To the extent that a capital requirement requires a greater amount of capital to be maintained for a G-SIB to engage in a low-return business like derivatives clearing than is warranted by the low risk of such business, G-SIBs will not be able to meet ROE targets without substantially raising prices. The Proposal, by including cleared derivatives in the Interconnectedness and Complexity Indicators in addition to the Size Indicator, would impose capital requirements disproportionate to the risks incurred by G-SIBs in clearing derivatives trades.

The Associations understand that if the Proposal were finalized, several G-SIBs expect to move up at least one "bucket" in the G-SIB Surcharge methodology, which would increase their G-SIB Surcharge capital requirements by billions of dollars in the aggregate.[12] A G-SIB's capital requirements attributable to derivatives clearing would be disproportionate to the activity's risks, as discussed in Part I above, as well as its returns.

In fact, we believe that the capital requirement increases due to the Proposal would be so disproportionate that G-SIBs would not be able to make a reasonable ROE for many client accounts. As a result, the Proposal would incentivize G-SIB FCMs to scale back their provision of clearing services to some clients outright, and limit the amounts cleared for others. This result would threaten clients' access to cleared derivatives. Because of mandatory clearing requirements for certain swaps under Title VII of the Dodd-Frank Act, clients may not be able to access those swaps in the United States. Additionally, the Proposal would remove an incentive for G-SIBs to migrate to central clearing any products that are not currently required to be cleared. These effects would be fundamentally inconsistent with the Pittsburgh G20 Commitments to promote central clearing and with Congress's clear policy choice in favor of clearing.

The Proposal could also impose barriers to porting derivatives from a distressed FCM to stable FCMs in times of system-wide stress. In a time of system-wide stress, when capital buffers decline, the G-SIB Surcharge is more likely to serve as a binding capital constraint on G-SIBs. If a larger book of cleared derivatives would substantially increase the amount of capital that a G-SIB had to maintain – as it could if the Proposal were finalized – G-SIBs would be less willing to take on new client positions from a distressed FCM. The G-SIB Surcharge would be pro-cyclical, intensifying market stress at exactly the wrong moment.

These likely effects of the Proposal are not merely theoretical. The Associations' members have already experienced reduced access to cleared derivatives as banking organizations have sought to reduce their total leverage exposure under the SLR, which is another capital requirement that overstates the exposure arising out of derivatives clearing. For instance, according to an AMG

12 *See* FIA and ISDA Comment on Unwarranted G-SIB Surcharge Capital Requirements (Oct. 11, 2017), *available at* https://fia.org/articles/fia-and-isda-comment-unwarranted-g-sib-surcharge-capital-requirements.

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member survey conducted last year, following the introduction of the SLR as a disclosure-only requirement, 50 percent of respondents were asked to "cap" the notional amount of their interest rate swaps outstanding with an FCM, and 30 percent of interest rate swap users were forced to terminate relationships with an FCM (and seek clearing services elsewhere, if possible).[13] We expect these effects to intensify as the SLR becomes a binding minimum capital requirement on January 1, 2018. We note, for example, that after the AMG member survey was completed, Deutsche Bank decided to exit the U.S. swaps clearing market due to the SLR.[14] We have not seen any indications that non-bank FCMs will fill the void. The Proposal would further exacerbate these effects and therefore increase systemic risk.

## III. The Proposal Lacks Supporting Analysis

The Federal Register notice and the Board's supporting statement[15] do not discuss the Proposal's effects on the G-SIB Surcharge's calibration of risk arising from derivatives clearing, nor the Proposal's negative impacts that raise concerns for members of the Associations, as discussed above. In fact, the Federal Reserve has not offered any economic analysis or data to justify the Proposal. We believe the Board must conduct and disclose this analysis before deciding to finalize the Proposal.

The Proposal also raises other issues that are not addressed in the Federal Register notice or the supporting statement, including the cumulative impact of the Proposal, when considered alongside the SLR and any other capital or liquidity rules imposed or due to be imposed on banking organizations, such as the Net Stable Funding Ratio; and any views of the CFTC, the primary market regulator of derivatives, and the Financial Stability Oversight Council, the interagency body with a mandate to address systemic stability, on the Proposal.

Without analysis of these issues in the Board's administrative record, it is difficult for the Associations to provide informed comment on the Proposal. Indeed, we believe the Board cannot make an adequately informed decision on whether to finalize the Proposal without conducting such analysis and soliciting comments from the public on it. Therefore, while we believe the Board should withdraw the Proposal entirely, we urge the Board at least to reissue the Proposal with analysis of these issues before finalizing it.

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13 AMG conducted the survey as of June 21, 2016, and twelve AMG members, representing an aggregate of over $1 trillion in assets under management, participated. More detailed survey results are available in our comment letter to the Basel Committee. *See* SIFMA AMG Submits Comments to the Basel Committee on Banking Supervision on Revisions to the Basel III Leverage Ratio Framework (June 30, 2016), *available at* https://www.sifma.org/resources/submissions/sifma-amg-submits-comments-to-the-basel-committee-on-banking-supervision-on-revisions-to-the-basel-iii-leverage-ratio-framework/.

14 Deutsche Bank Is Said to Close U.S. Swaps-Clearing Business, Bloomberg (Feb. 8, 2017), *available at* https://www.bloomberg.com/news/articles/2017-02-09/deutsche-bank-is-said-to-close-u-s-swaps-clearing-business.

15 *See* Board of Governors of the Federal Reserve System, Supporting Statement for the Banking Organization Systemic Risk Report (FR Y-15; OMB No. 7100-0352), *available at* https://www.federalreserve.gov/reportforms/formsreview/FR%20Y-15_20170824_OMB%20SS.pdf.

We appreciate the Board's consideration of our concerns. Should you have any questions, please do not hesitate to contact Tim Cameron (at (202) 962-7447 or tcameron@sifma.org) or Laura Martin (at (212) 313-1176 or lmartin@sifma.org) at AMG, or Stuart Kaswell at (202) 730-2600 or skaswell@managedfunds.org) or Laura Harper Powell (at (202) 730-2947 or lharperpowell@managedfunds.org) at MFA.

Respectfully submitted,

/s/ Laura Martin
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SIFMA Asset Management Group – Managing Director and Associate General Counsel

/s/ Stuart J. Kaswell
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## Appendix

## Descriptions of the Associations

### Securities Industry and Financial Markets Association's Asset Management Group

SIFMA AMG brings the asset management community together to provide views on policy matters and to create industry best practices. AMG's members represent U.S. and multinational asset management firms whose combined global assets under management exceed $39 trillion. The clients of AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS, and private funds such as hedge funds and private equity funds.

### Managed Funds Association

MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals, and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.