Meeting Between Staff of the Federal Reserve Board and Representatives of the Futures Industry Association
February 20, 2024

Participants: Brian Chernoff, Sarah Dunning, Isabel Echarte, Akos Horvath, Alex Jiron, Jonah Kind, David Lynch, Jennifer McClean, and Travis Nesmith (Federal Reserve Board)

Jacqueline Mesa, Kyle Glenn, and Walt Lukken (Futures Industry Association); Randy Benjenk (Covington & Burling); Tom Gillis (Wells Fargo); Andrew Nash and Daniel Wiebicke (Morgan Stanley); Helen Gordon (JPMorgan); Joseph Hwang (Goldman Sachs); Mariam Rafi (Citigroup); and Bengt Redlinger (Bank of America)

Summary: Staff of the Federal Reserve Board met with representatives of the Futures Industry Association, Covington & Burling, Wells Fargo, Morgan Stanley, JPMorgan, Goldman Sachs, Citigroup, and Bank of America (collectively, the FIA) regarding the Board's GSIB surcharge proposal. FIA representatives discussed concerns about the impact of the GSIB surcharge proposal, particularly as it relates to derivatives clearing activities.

Attachment

The US GSIB Surcharge and Basel III Endgame Proposals Threaten Access to Cleared Derivatives Markets

February 2024

Topline Numbers

Capital Requirement Attributable to Six US GSIBs' Client Clearing Activity as of June 30, 2023*

	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%

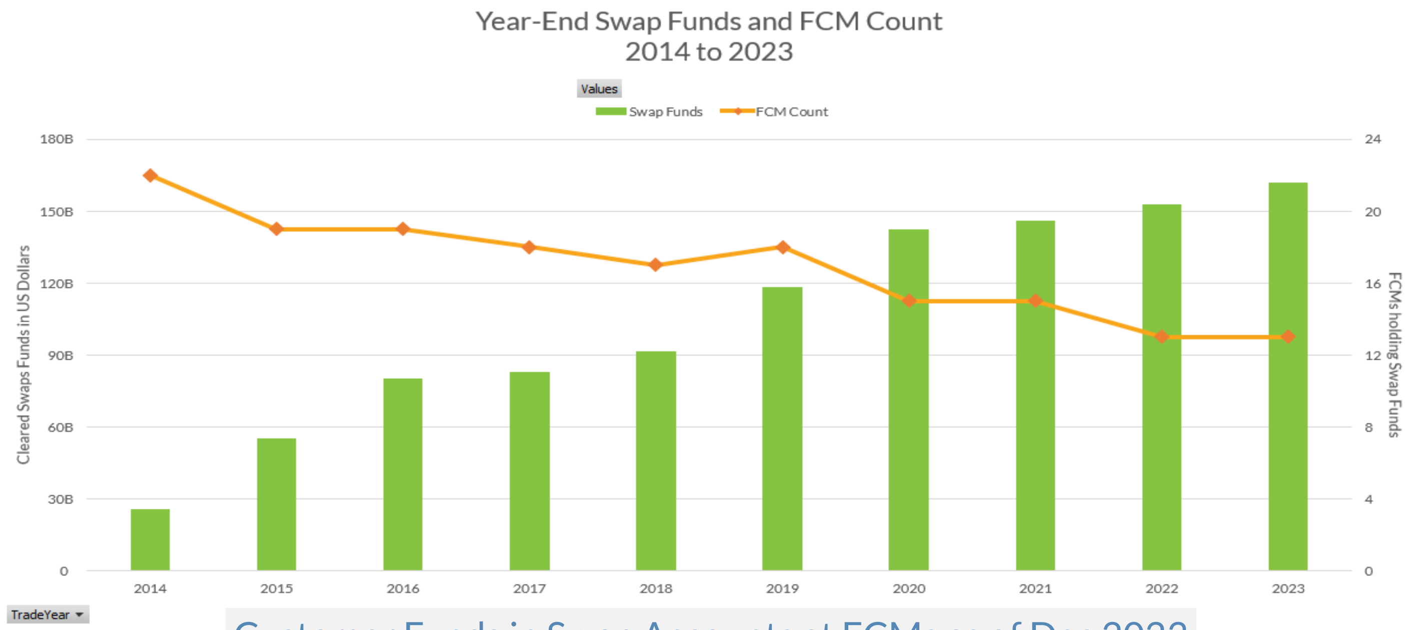
*The data collection and analysis for this quantitative impact study (QIS) was conducted by the GARP Benchmarking Initiative (GBI)®, a division of the Global Association of Risk Professionals® (GARP). GARP®, a nonpartisan, non-profit corporation, is the world's leading professional association for risk 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.

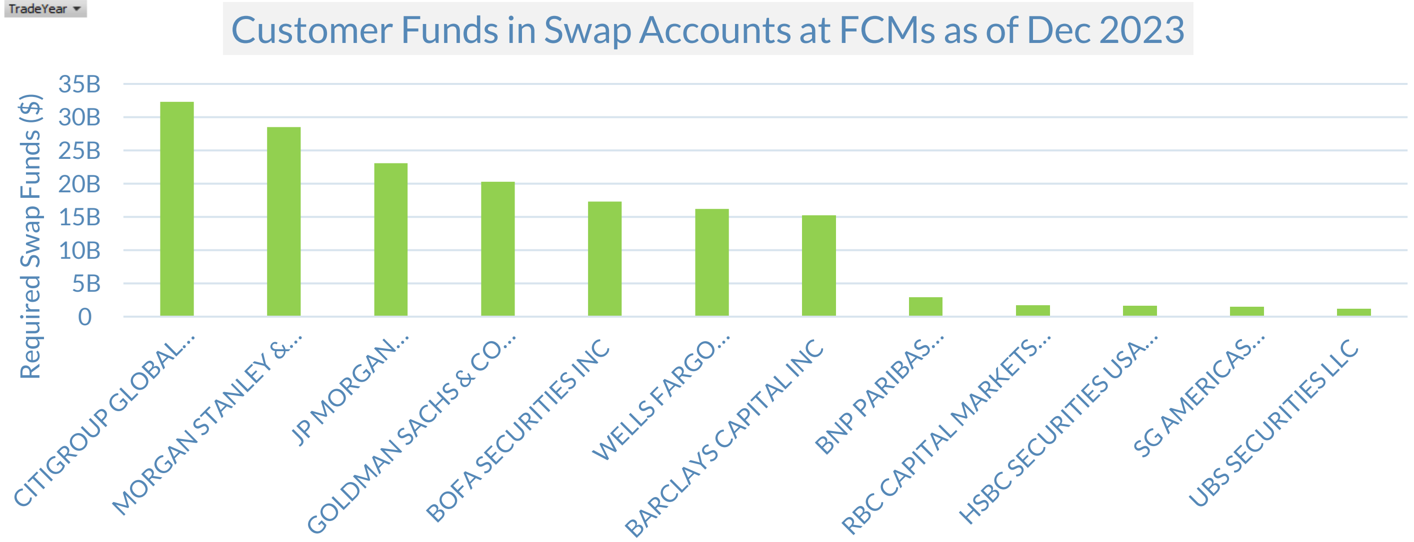
**We calculated this capital impact of $5.20 billion by reflecting the changes to the six participating firms' Method 2 G-SIB Surcharge scores arising from the Surcharge Proposal's changes to the treatment of client clearing activities. Specifically, the net increase takes account of the increases to 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.

Centrally Cleared Derivatives Market Challenges

- In the US, firms that clear derivatives for clients must be registered with the Commodity Futures Trading Commission as "Futures Commission Merchants" (FCMs).
- There are a limited number of banks that provide clearing services for over-the-counter (OTC) derivatives.
- At the same time, following the 2008 Financial Crisis, US and Global regulators recognized the risk reducing role of clearing and mandated certain OTC contracts for central clearing.
  - Clearing reduces systemic risk
- Following the introduction of Dodd-Frank Act reforms, there were twenty-two FCMs providing OTC client clearing in 2014. [CFTC mandatory clearing started in March 2013]
- As of year end 2023, there were twelve FCMs offering OTC client clearing services in the US:
  - The top seven banks comprise 94% of the market
  - The top six banks are US BHCs and comprise 85% of the market

Swap Clearing: Rising Demand, Falling Supply, Dominated by US BHCs





Source: FIA FCM Tracker

Impact of the GSIB Surcharge Proposal

- The Federal Reserve Board estimated in the NPR that the combined effect of all changes would increase method 2 GSIB <u>firm wide total scores</u> by approximately 27 points on average across firms (13-basis-point increase in the average method 2 GSIB capital surcharge).
  - the preamble states the largest contributors to the projected increase would come from including derivatives exposures in the Cross-Jurisdictional Activity indicators (11 points) and averaging data points underlying the indicators (9 points)
  - the FRB has not provided an estimate of the specific impact the proposal would have on client clearing
- Five of the six QIS GSIB participants reported meaningful increases to their Method 2 GSIB Surcharge scores driven by 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 would increase their Method 2 GSIB Surcharge scores by an average of:
  - **<u>13.9 points in the Complexity indicator</u>**, and
  - 0.9 points in the Interconnectedness indicator
- This would result in a capital equivalent increase of **$5.20bn industry wide increase across all US GSIB FCMs,** or in percentage terms **58%** relative to current capital requirements under US Standardized.

Impact of the GSIB Surcharge Proposal cont.

- The GSIB Surcharge has a firm-wide impact, that can have a multiplier effect on an entire bank's capital requirements.
- The proposal would increase the likelihood that an OTC client clearing business is responsible for tipping the whole firm into a higher GSIB Surcharge bucket and thus increasing its firmwide capital requirement.
  - Porting Concerns - The Proposal casts serious doubt about the viability of client porting. A Bank taking on a substantial book of new clients would significantly increase capital requirements - *potentially at a firmwide level*.
- The increased capital requirements being proposed will **substantially** disincentive US GSIBs from offering OTC client clearing services, resulting in further concentration of OTC clearing service providers and possible access issues for some market participants.
- The Proposals may also incentivize some US GSIBs 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, if a firm is required to maintain an additional $1 billion in capital to continue to engage in OTC client clearing activities, 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.

The GSIB Surcharge Creates an Unlevel Playing Field

- **Competitive Imbalance**
  - International regulators, including in the UK and EU, continue to view client clearing under the agency model where the bank guarantee of performance of the client does not add to the Complexity indicator. In this regard it is unclear why the US rule seeks to diverge from this international consensus.
  - The Basel Committee on Banking Supervision's latest reporting instructions for the international GSIB Surcharge assessment exclude from the Complexity indicator cleared OTC derivative transactions in which a clearing member GSIB, acting as agent, guarantees client's performance to the CCP.
  - The Surcharge Proposal would disadvantage US GSIBs versus competitors based abroad who use the agency clearing model.
    - Such a competitive imbalance could distort the OTC derivatives clearing markets and shift OTC client clearing activity to non-US GSIBs.
    - This concern is particularly acute because the US GSIB Surcharge rule is *already* diverging through the use of Method 2, which generally produces higher capital requirements than the standards that apply to GSIBs based outside the US.

	BCBS Instructions for the end-2023 GSIB assessment exercise	Current US GSIB Surcharge Framework (FR Y-15 Instructions)	Proposed amended US GSIB Surcharge Framework
	Complexity	Complexity	Complexity
Clearing member guarantee of CCP performance to the client	Included	Included	Included
Clearing member guarantee of client performance to the CCP	Not included	Not included	Included

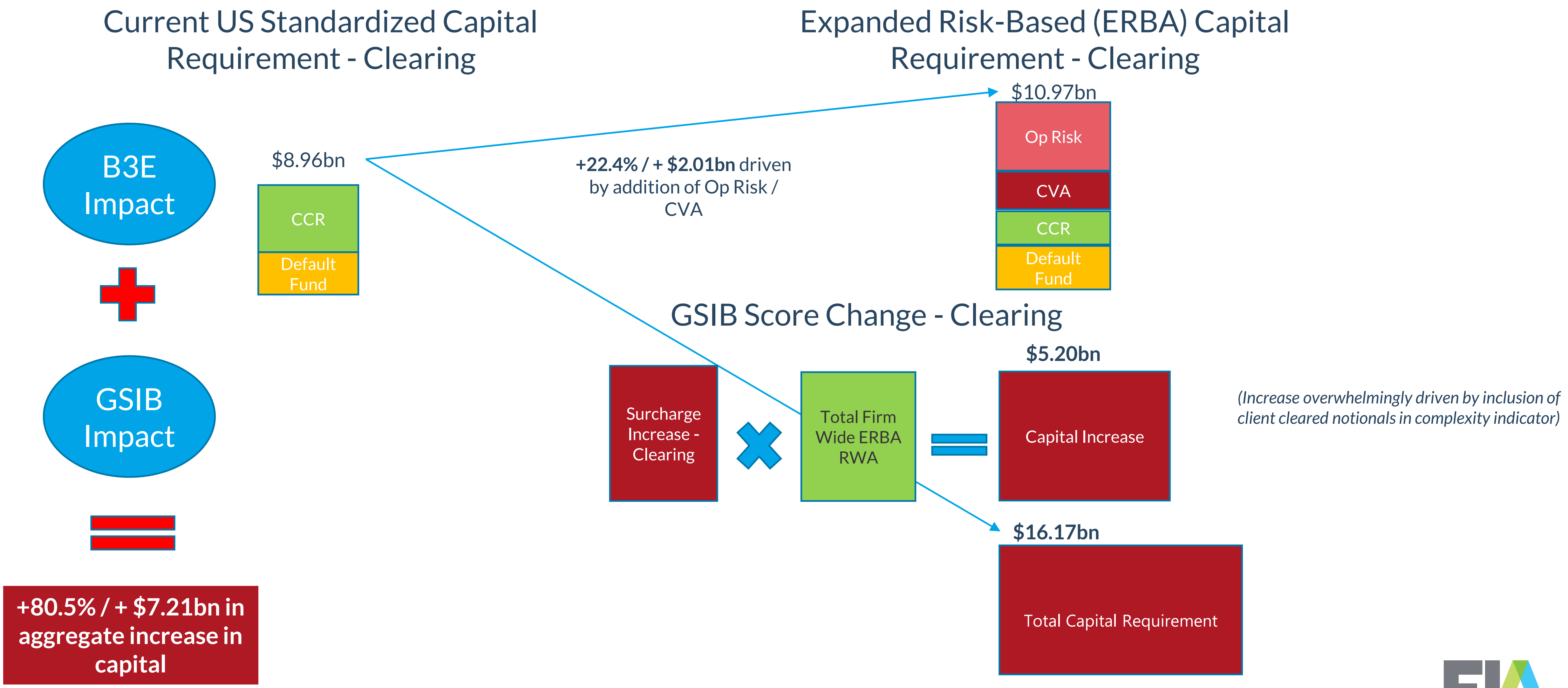
Context of GSIB Surcharge Proposal from 2017

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

- In our view nothing has changed since 2017 that would undermine this reasoning.
- LCH reports clearing over 90% of all cleared interest rate swaps globally as measured by notional amount.
- Since 2017, LCH reports that client cleared trades of OTC derivatives has more than doubled in 2022.
- In first six months of 2023 more than 80% of the notional swaps were cleared under the agency model.
  - Of the OTC interest rate swaps cleared through LCH under the agency model, 45% of clients (measured by number of clients) are domiciled outside the United States.
- The agency model was the first model offered for OTC clearing and is known by clients, tested and resilient.

Cumulative Impacts of B3E and GSIB on Clearing



Conclusion

- FIA urges the Federal Reserve Board to **not** add the clearing member guarantee of client performance to a clearinghouse into the *Complexity and Interconnectedness* indicators of the Surcharge.
- The six US GSIBs that are the most significant clearing members in the US maintain over $8.96 billion* in capital solely to engage in client clearing activities.
- If adopted as proposed, **the GSIB Surcharge Proposal and Endgame Proposal will increase the capital requirements for the six most significant clearing members in the US by $7.21 billion or 80.5%.**
  - The overwhelming increase in capital requirements is driven by inclusion of client cleared notionals in complexity indicator of the GSIB Surcharge.
  - Disproportionately high capital requirements will cause higher costs for clearing for end-users and for banking organizations to reconsider, or potentially reduce their clearing activity, which increases systemic risk and harms end-users' access to risk management markets.

*As of June 30, 2023

Appendix – Basel III Endgame Proposal Data

- The Endgame Proposal's regulatory capital treatment of derivatives clearing activities would impose disproportionately high capital requirements on clearing (futures, options, and OTC), and disincentivize banking organizations from offering those services to clients.
- According to our QIS study, this proposal alone would increase the capital required for these six firms to engage in their current scope of client clearing activities by more than **22%**, or over **$2.01 billion** in the aggregate.

	Percentage Increase in Capital Requirement
Operational Risk Framework	79%
CVA Framework	36%

**These numbers do not sum to 100 percent because the Endgame Proposal would make other changes to the counterparty credit risk framework that would decrease risk-weighted assets compared to the current US standardized approach.*

Appendix - FIA Recommendations for the Proposals

GSIB Recommendations
Do not add the clearing member guarantee of client performance to a clearinghouse a client cleared transaction in the Complexity and Interconnectedness indicators
Endgame Recommendations
Revise the Proposal's approach to calculating the services component of operational risk
Exclude exposures arising from client clearing of derivatives from the CVA framework
Omit the Proposal's requirement for an investment grade obligor to be publicly traded to be eligible for a lower risk weight
Revise SA-CCR to permit netting of STM and CTM transactions against each other even when they are not "cleared transactions," a term that the capital rules define to exclude client clearing
Withdraw the Proposal's changes that would prohibit the decomposition of nonlinear instruments on indices within SA-CCR

FIA