



March 18, 2019

VIA ELECTRONIC SUBMISSION

Ann E. Misback, Secretary  
Board of Governors of the Federal Reserve  
System  
20th Street and Constitution Avenue, NW  
Washington, D.C. 20551  
Docket No. R—1629; RIN 7100—AF22

Legislative and Regulatory Activities  
Division  
Office of the Comptroller of the Currency  
400 7th Street, SW  
Suite 3E-218  
Washington, D.C. 20219  
Docket ID OCC—2018—0030

Robert E. Feldman, Executive  
Secretary  
Federal Deposit Insurance Corporation  
550 17th Street, NW  
Washington, D.C. 20429  
RIN: 3064—AE80

**Re: Standardized Approach for Calculating the Exposure Amount of  
Derivative Contracts**

Ladies and Gentlemen:

The Financial Services Forum (the “Forum”)<sup>1</sup> appreciates the opportunity to submit this letter to the Board of Governors of the Federal Reserve System (the “FRB”), the Federal Deposit Insurance Corporation (the “FDIC”), and the Office of the Comptroller of the Currency (the “OCC,” and collectively with the FRB and the FDIC, the “Agencies”) on the notice of proposed rulemaking (the “Proposal”) that would implement a new approach for calculating the exposure amount of derivative contracts under the Agencies’ regulatory capital rule, referred to as the standardized approach for counterparty credit risk (“SA-CCR”).<sup>2</sup> The proposed changes would

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<sup>1</sup> The Financial Services Forum is an economic policy and advocacy organization whose members are the chief executive officers of the eight largest and most diversified financial institutions headquartered in the United States. Forum member institutions are a leading source of lending and investment in the United States and serve millions of consumers, businesses, investors, and communities throughout the country. The Forum promotes policies that support savings and investment, deep and liquid capital markets, a competitive global marketplace, and a sound financial system.

<sup>2</sup> 83 Fed. Reg. 64660 (Dec. 17, 2018).

apply to all of our member institutions, the U.S. global systemically important bank holding companies (“GSIBs”). Ultimately, the ability of our member institutions to serve as a leading source of lending and investment for U.S. consumers, businesses, investors, and communities critically depends on the efficient calibration of regulation that accounts for, and that balances, effective costs and benefits. Financial regulations that do not adhere to these key principles result in an inefficient financial system that misallocates capital in a way that can have a detrimental effect on the businesses and households that we serve. In this letter, we describe how the Proposal should be revised to adhere to these principles.

### *Executive Summary*

We support revisiting the decades-old methodology for measuring derivatives exposures, referred to as the “current exposure method” (“CEM”), which the Agencies acknowledge is not sufficiently risk sensitive.<sup>3</sup> However, in light of our member institutions’ strong capital positions,<sup>4</sup> the need to bring efficiencies to the post-crisis framework, and the acknowledged policy concern that the sustainability of economic growth depends on fostering investment from businesses and households,<sup>5</sup> the Proposal and any other contemplated refinements to the Agencies’ capital regulations should be calibrated to avoid unnecessarily increasing the current aggregate level of capital for GSIBs.<sup>6</sup> Moreover, in furtherance of this goal, SA-CCR should be designed and adopted as part of a comprehensive and transparent evaluation of the interactions between the Proposal and the Agencies’ other contemplated changes to the regulatory capital framework, and the potential impact

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<sup>3</sup> *Id.* at 64662 (“SA-CCR would provide important improvements to risk-sensitivity and calibration relative to CEM”).

<sup>4</sup> Our member institutions currently maintain \$900 billion of tier 1 capital. *See* Forum, The Value and Strength of America’s Largest Financial Institutions, 18 (Nov. 2018), [https://www.fsforum.com/wp-content/uploads/2018/11/forum\\_value-and-resiliency\\_nov2018.pdf](https://www.fsforum.com/wp-content/uploads/2018/11/forum_value-and-resiliency_nov2018.pdf).

<sup>5</sup> FRB Vice Chairman Randal K. Quarles, An Assessment of the U.S. Economy, Speech at the 34th Annual NABE Economic Policy Conference (Feb. 26, 2018) (noting that the “sustainability of the recent upturn in growth will depend importantly” on developments in factors such as capital investment).

<sup>6</sup> This objective would be consistent with FRB Vice Chairman Quarles’s recent testimony to the Senate Banking Committee, during which he stated that, as applied to our member institutions, current “capital levels, the total loss absorbency capital capacity in our system is roughly about right.” *Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. (2018) (testimony of FRB Vice Chairman Randal K. Quarles). The Basel Committee on Banking Supervision (the “Basel Committee”) has expressed a similar point, noting the goal of “not significantly increasing overall capital requirements” in finalizing its Basel III framework (“Basel III finalization”). Basel Committee, *Basel III: Finalising post-crisis reforms 1* (Dec. 7, 2017).

of all such changes on our member institutions' customers, including commercial end users.

Therefore, and as explained in more detail below, we make the following recommendations.

- **The Proposal Should Be Revised to Be Consistent with the Congressional Determination to Avoid Unnecessary Costs for Commercial End Users.** The Proposal would lead to a 550-plus percentage point increase in the capital costs associated with providing risk management products to many commercial end users.<sup>7</sup> Without modification of this aspect of the Proposal, commercial end users, such as state and local governments, hospitals and other not-for-profit corporations, electricity cooperatives, and airlines, are likely to face significantly increased costs of managing their risks and even could face reduced access to risk management products. As a result, businesses and public sector entities likely would face higher operating costs, which would lead to higher prices for consumers and add friction to the economy – all without a commensurate policy benefit. Furthermore, imposing such a steep cost increase on risk management products used by commercial clients would be inconsistent with statutory exemptions for commercial end users from mandatory clearing and margin requirements for over-the-counter swaps.<sup>8</sup> These exemptions reflect congressional intent to permit our member institutions' commercial clients to continue managing risks without an undue cost increase. To avoid this result, the Agencies should revise the Proposal to reduce the capital requirements for unmargined swaps with commercial end users.

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<sup>7</sup> The details of the analysis of the Proposals' effect on such transactions are set forth on the attached [Exhibit A](#).

<sup>8</sup> The Dodd-Frank Act exempted certain commercial entities from mandatory swaps and security-based swaps clearing. *See* 7 U.S.C. § 2(h)(7)(A); 15 U.S.C. § 78c-3(g)(1). The Terrorism Risk Insurance Program Reauthorization Act of 2015 ("[TRIPRA](#)") expanded the exemption to exempt swaps from mandatory initial and variation margin requirements where one of the parties is a commercial end user and uses swaps to hedge or mitigate commercial risk or is eligible for a public interest exemption from swaps clearing requirements for certain cooperative entities. *See* 7 U.S.C. § 6s(e)(4); 15 U.S.C. § 78o-10(e)(4). Separately, the Agencies and the Commodity Futures Trading Commission excluded swaps with commercial end users from mandatory margin requirements under the Dodd-Frank Act, recognizing that such swaps pose less risk to the financial system. *See* 80 Fed. Reg. 74840, 74843 (Nov. 15, 2015) ("In implementing this risk-based approach, the final rule distinguishes among four separate types of swap counterparties: (i) Counterparties that are themselves swap entities; (ii) counterparties that are financial end users with a material swaps exposure; (iii) counterparties that are financial end users without a material swaps exposure, and (iv) other counterparties, including nonfinancial end users, sovereigns, and multilateral development banks.").

- **A Comprehensive Impact Study Is Needed to Analyze How the Proposal Fits with the Broader Regulatory Capital Framework and the Impact on Customers, Including Commercial End Users; Mandatory Adoption Should Be Delayed Until This Assessment Is Complete.** The Agencies should conduct a comprehensive quantitative impact study that analyzes the Proposal and, more broadly, the full regulatory capital framework, including expected impacts of other contemplated changes. As a part of the study, the Agencies should evaluate SA-CCR's calibration, including an assessment of whether the proposed calibration is overly conservative,<sup>9</sup> to avoid unnecessarily increasing overall capital requirements for our member institutions.<sup>10</sup>
  - To provide sufficient time for completion of this work, SA-CCR should be mandatorily effective no earlier than the effective date of Basel III finalization in the United States (the "Basel III Implementation Date").<sup>11</sup>
  - Once the Proposal has been finalized, firms should have the ability to early-adopt SA-CCR before the Basel III Implementation Date. This approach is consistent with the Proposal, which contemplates a transition period, but also would allow for early adoption before the mandatory compliance deadline.<sup>12</sup>
- **The SA-CCR Framework Should Be Used Consistently Throughout the Agencies' Prudential Standards.** The Agencies also should conduct a comprehensive review of their regulations and adopt the SA-CCR framework uniformly across their regulations wherever a particular regulation calls for quantification of counterparty credit risk exposures arising from derivatives contracts, unless there is compelling policy rationale for not doing so.

We have focused this letter on policy issues that are key priorities for our member institutions to help ensure that the regulatory capital framework is appropriately

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<sup>9</sup> We urge the Agencies to review and consider the quantitative impact study conducted by the International Swaps and Derivatives Association ("ISDA"), which is discussed in ISDA's comment letter.

<sup>10</sup> Proposal at 64666 (Question 3 asks whether the objective of ensuring that SA-CCR produces more conservative exposure amounts than the internal models methodology is appropriate).

<sup>11</sup> Under the Basel Committee's framework, Basel III finalization would start to be phased in on January 1, 2022.

<sup>12</sup> Proposal at 64662.

designed and calibrated to support continued economic growth. We also support the comments submitted by ISDA.

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***The Proposal Should Be Revised to Be Consistent with the Congressional Determination to Avoid Unnecessary Costs for Commercial End Users.*** Based on analysis by our member institutions, SA-CCR would result in significant increases in exposure amounts for unmargined swaps, which commercial clients typically use to hedge risks arising in their businesses. For example, the exposure amount for a typical unmargined commodity derivative that one of our member institutions might enter into with an electricity cooperative or airline would increase by over 550 percent compared to CEM.<sup>13</sup> As another example, the exposure amount for a typical unmargined interest rate swap with a municipality to hedge the interest rate risk of the municipality's bonds would increase by approximately 66 percent compared to CEM.<sup>14</sup>

The Proposal would lead to these results for unmargined swaps despite the fact that many commercial end users are not able to post margin. For example, some of these customers do not operate businesses that generate excess cash that could be available to post as margin, while others, including certain public sector entities, are prohibited by statute from posting margin. As a result, banking organizations tend to manage risk differently for these transactions, such as by using letters of credit. Nevertheless, the Proposal would lead to a drastic increase in capital requirements, which very well may result in our member institutions being unable to serve as counterparties to these commercial end users in an economical way. Consequently, the Proposal would result in: (1) increased costs for commercial end users to manage risk (as a result of the attendant higher capital costs); (2) regulatory fragmentation that gives rise to an uneven playing field between the advanced approaches firms that are required to use SA-CCR, on the one hand, and non-advanced approaches firms that would be able to use CEM or nonbank financial institutions not subject to regulatory capital requirements, on the other hand;<sup>15</sup> or (3) commercial end users being limited in their

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<sup>13</sup> See Exhibit A.

<sup>14</sup> *Id.*

<sup>15</sup> Although non-advanced approaches firms that would be able to continue using CEM might be able to absorb some of this business, it is unlikely that all of the volume that our member institutions provide would be able to be absorbed. For example, based on FR Y-9C, Schedule HC-L data as of Q3 2018, our member institutions accounted for 93% of all derivatives exposures among FR Y-9C reporters, which suggests that other market participants may not be able to replace lost volume.

ability to hedge risk at all. In all cases, the result likely will be higher prices for consumers, which would create headwinds for continued growth.<sup>16</sup>

Moreover, this aspect of the Proposal would undermine clear congressional intent. Specifically, these increased costs would be inconsistent with statutory exemptions for commercial end users from mandatory clearing and swaps margin regulations, which recognize the unique circumstances that commercial end users face and reflect congressional intent to permit commercial clients to continue to manage risks associated with their underlying businesses without undue cost burdens.<sup>17</sup> In other words, the same policy imperative that motivated Congress in the past to exempt commercial end users from swaps margin and clearing requirements applies here: SA-CCR should not result in prohibitively higher costs for commercial risk management, which effectively would divert resources from investments and growth. Accordingly, we urge the Agencies to revise the Proposal to avoid the application of such high capital costs on unmargined swaps with commercial end users.<sup>18</sup> In this regard, we agree with the ISDA recommendation to reduce the SA-CCR exposure amounts for unmargined transactions with commercial end users by not applying the 1.4 alpha factor to such transactions.

***A Comprehensive Impact Study Is Needed to Analyze How the Proposal Fits with the Broader Regulatory Capital Framework and the Impact on Customers, Including Commercial End Users; Mandatory Adoption Should Be Delayed Until This Assessment Is Complete.*** In the Proposal, the Agencies ask about considerations relevant to the determination of whether to replace CEM with SA-CCR and alternative timing that should be considered.<sup>19</sup> One such consideration that

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<sup>16</sup> In this regard, we urge the Agencies to consider comments submitted by commercial end users explaining the potential impact of the Proposal on their businesses.

<sup>17</sup> In a 2010 letter to then-Congressman Barney Frank and Congressman Collin Peterson, then-Senators Christopher Dodd and Blanche Lincoln explained that “[i]f regulators raise the costs of end-users transactions, they may create more risk” and that “[i]t is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end-users or impair economic growth.” Letter from Sens. Christopher Dodd and Blanche Lincoln, dated June 30, 2010, <http://online.wsj.com/public/resources/documents/dodd-lincoln-letter070110.pdf>. Senator Michael Crapo also has pointed out that “[f]orcing end-users to post margin ... could cause harmful effects for the economy and consumers” and that “[i]f end-users are posting a margin, those funds are unavailable for investment in jobs and expansion.” 161 Cong. Rec. S72-02 (2015) (statement of Sen. Michael Crapo). These concerns were reflected in TRIPRA, which explicitly carves out commercial entities from margin regulations mandated by the Dodd-Frank Act.

<sup>18</sup> For this purpose, the same definition of “commercial end users” could be the same as the definition of “non-financial end users” that are not required to post margin under the Agencies’ rules for uncleared swaps margin.

<sup>19</sup> Proposal at 64663 (Questions 1 and 2).

the Proposal does not discuss in sufficient detail is the interaction between the Proposal and certain other current and contemplated future elements of the Agencies' regulatory capital framework. As explained below, we believe that changes are needed to ensure that the Proposal forms part of a coherent, consistent prudential framework.

The need for coherence is underscored by the fact that the Proposal is one of several published by the Agencies that seek to refine the post-crisis capital framework. Other relevant components of the regulatory agenda include proposals to introduce a stress capital buffer ("SCB"),<sup>20</sup> revise the enhanced supplementary leverage ratio,<sup>21</sup> and revise the applicability thresholds for various capital and liquidity requirements (including the advanced approaches thresholds).<sup>22</sup> In addition, the Agencies have expressed support for Basel III finalization, stating that they are considering "how to appropriately apply these revisions to the Basel III reform package in the United States."<sup>23</sup> Although the Proposal briefly discusses the potential interaction between SA-CCR and certain of the Agencies' current requirements and currently outstanding and contemplated proposals, this discussion and analysis needs to be expanded considerably.<sup>24</sup> In particular, the Agencies do not comprehensively address the interaction between the Proposal and (1) U.S. implementation of Basel III finalization, (2) the SCB and the FRB's Comprehensive Capital Analysis and Review ("CCAR") program, or (3) the GSIB surcharge. The Agencies also do not address the potential impact that the Proposal might have on customers, including commercial end users.

To address this shortcoming, the Agencies should conduct a comprehensive quantitative impact study that analyzes the net cumulative impact on capital levels across the industry of the entire suite of existing, proposed and contemplated regulatory capital rules. Early during FRB Vice Chairman Quarles's tenure, he asked FRB staff "to conduct a comprehensive review of the regulations in the core areas of reform ... capital, stress testing, liquidity, and resolution," and explained that the objective was to "consider the effect of those regulatory frameworks on resiliency

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<sup>20</sup> 83 Fed. Reg. 18160 (Apr. 25, 2018).

<sup>21</sup> 83 Fed. Reg. 17317 (Apr. 19, 2018).

<sup>22</sup> 83 Fed. Reg. 66024 (Dec. 21, 2018).

<sup>23</sup> Agencies, Joint Press Release, U.S. banking agencies support conclusion of reforms to international capital standards (Dec. 7, 2017). *See also* 83 Fed. Reg. at 66027 (noting that the Agencies are considering amendments to their capital rule that would take into account Basel III finalization).

<sup>24</sup> *See, e.g.*, Proposal at 64663 (discussing the interaction between the Proposal and the FRB's single-counterparty credit limits rule and the Agencies' proposed net stable funding ratio rule).

and resolvability of the financial system, on credit availability and economic growth, and more broadly to evaluate their costs and benefits.”<sup>25</sup> The impact of the Proposal should be included as part of this review, and we urge the FRB to coordinate with the other Agencies on this study and to make public the results and underlying analysis.

This exercise will inform how SA-CCR and other aspects of the framework should be calibrated and designed to fit together most efficiently. Importantly, a comprehensive impact assessment will allow for coherent calibration of the entire regulatory capital regime that does not result in an unnecessary increase in required capital. After that exercise, using the Basel III Implementation Date as the mandatory effective date for SA-CCR would allow SA-CCR and Basel III finalization to come into force after having been appropriately calibrated in unison. In addition, as currently contemplated by the Proposal, firms should be able to early-adopt SA-CCR once it is finalized and appropriately calibrated.<sup>26</sup> Finally, while we recognize that the Proposal includes an impact assessment of SA-CCR in isolation, such an assessment is not sufficient to ensure appropriate calibration of SA-CCR in relation to the entire regulatory framework. For example, interactions between SA-CCR and related aspects of the capital regime may result in an over-calibration of SA-CCR that is difficult or impossible to detect without a broader impact assessment. To illustrate this point, below we describe ways in which SA-CCR calibration should be considered in light of Basel III finalization and the SCB proposal and CCAR. We then highlight why the proposed calibration of SA-CCR should be revisited more generally, including with respect to the 1.4 alpha factor and gold plating of Basel Committee standards.

*Basel III Finalization.* The Basel Committee adopted SA-CCR in 2014 to take effect on January 1, 2017. Subsequently, in December 2017, the Basel Committee finalized a set of revisions to its Basel III framework, due to take effect beginning on January 1, 2022. Basel III finalization includes significant revisions to the framework for calculating credit risk-weighted assets.<sup>27</sup> Given that the revised Basel III framework no longer uses CEM, Basel III finalization presumably was completed and calibrated on the assumption that the 2014 SA-CCR standards would be part of the broader

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<sup>25</sup> FRB Vice Chairman for Supervision Randal K. Quarles, Early Observations on Improving the Effectiveness of Post-Crisis Regulation, Speech at the American Bar Association Banking Law Committee Annual Meeting (Jan. 19, 2018).

<sup>26</sup> Along similar lines, once the Proposal is finalized, firms also should be permitted to early adopt the revised “comprehensive approach” for calculating counterparty credit exposures to securities financing transactions. *See infra* note 33.

<sup>27</sup> The framework also includes significant revisions to the internal ratings-based approach for credit risk, minimum capital requirements for credit valuation adjustment (“CVA”) risk, minimum capital requirements for operational risk, the leverage ratio, and introduces an output floor.



Basel Committee capital framework.<sup>28</sup> Notably, in making these changes, the Basel Committee said that the effort was “focused on not significantly increasing overall capital requirements.”<sup>29</sup>

In the United States, however, the Agencies have not yet indicated how they will seek to implement Basel III finalization. Therefore, it is not clear whether the calibration of SA-CCR in the Proposal, when coupled with the ultimate implementation of Basel III finalization in the United States, will result in neutral capital levels, which is the stated policy objective of the Basel Committee and FRB Vice Chairman Quarles.<sup>30</sup> Moreover, uneven implementation is likely to have cumulative impacts that are hard to analyze or understand in isolation. For example, in recent years, the Basel Committee has introduced a number of revisions to the Basel III framework focused on capital markets activities, including: SA-CCR in 2014; revisions to counterparty risk weights and the CVA risk framework, and introduction of a framework for capital requirements to implement minimum haircut floors for non-centrally cleared securities financing transactions, all pursuant to Basel III finalization in 2017;<sup>31</sup> and a revised market risk capital rule, commonly referred to as the “fundamental review of the trading book” or (“FRTB”), in 2016, with further revisions finalized in 2019.<sup>32</sup> Yet neither the Basel Committee nor the Agencies have analyzed or sought public comment on the potential cumulative impact of these standards on financial intermediation (which, of course, is key to economic growth). As one example of an impact that has not been analyzed, a firm’s derivatives activities could be simultaneously affected by the changes to the standardized counterparty risk weights, SA-CCR, the CVA framework revisions and FRTB. Accordingly, analyzing each proposal in isolation does not provide an accurate assessment of the potential impacts.

To achieve the ultimate goal of maintaining an appropriate level of capital at the GSIBs and to avoid temporary distortive effects caused by uneven implementation,<sup>33</sup> Basel III finalization and SA-CCR should have the same mandatory effective date.

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<sup>28</sup> Basel Committee, The standardised approach for measuring counterparty credit risk exposures (Mar. 31, 2014) (“Basel SA-CCR”). *See also* Basel III finalization at 138 (in calculating the output floor that is part of Basel III finalization, firms must use SA-CCR).

<sup>29</sup> Basel III finalization at 1. *See also supra* note 6.

<sup>30</sup> Basel III finalization at 1.

<sup>31</sup> *See id.* at 45-47.

<sup>32</sup> Basel Committee, Minimum capital requirements for market risk (Jan. 14, 2019).

<sup>33</sup> For example, among the changes contemplated by Basel III finalization are revisions to the “comprehensive approach” for calculating counterparty credit exposures to securities financing transactions that, much like SA-CCR, improve upon the risk-sensitivity of the current approach. *See* Basel III finalization at 44-45.

In the meanwhile, the Agencies should undertake the quantitative impact study that we suggest to evaluate the entire suite of changes that are contemplated (including Basel III finalization) and use that impact assessment to inform how each piece of the framework should be calibrated and implemented.

*Stress Capital Buffer and CCAR.* SA-CCR also should be evaluated and calibrated in light of the FRB's proposed SCB, which would integrate a firm's supervisory stress test results under CCAR with the standardized capital conservation buffer. Neither the SCB proposal nor the SA-CCR proposal address the potential impact of SA-CCR adoption on SCB levels across the banking industry, or its interaction with CCAR and its global market shock and large counterparty default (the "LCPD") components. Of course, SCB levels will be critical in determining overall capital requirements for GSIBs.

CCAR assesses the quantitative impact of certain prescribed macroeconomic scenarios on a firm's standardized risk-based capital ratios. With respect to a firm's derivatives portfolio, CCAR assesses the impact of those macroeconomic scenarios using CEM to determine a firm's risk-weighted assets. Because the Proposal would modify the calculation of exposure amounts for derivatives under the standardized approach for our member institutions by replacing CEM with SA-CCR, the Proposal also could impact the contribution of a firm's derivatives portfolio to stress losses under CCAR. Therefore, the Proposal could impact significantly how a firm's SCB levels respond to different macroeconomic shock scenarios. Yet, this potential impact is neither acknowledged nor discussed in the Proposal. The potential impact also was not considered in the context of the earlier SCB proposal.

These concerns are particularly important in terms of understanding whether and the extent to which the SCB would exacerbate volatility in the capital planning process. FRB Vice Chairman Quarles has voiced concerns about such volatility, stating that the issue is "foremost" on his mind, and that volatility of stress test results (and therefore in SCB levels) "can lead to capital requirements that change significantly from year to year, which limits a firm's ability to manage its capital effectively."<sup>34</sup> Further, concerns about volatility are likely to be exacerbated if the SCB takes effect on or around the date the Agencies propose for SA-CCR to become fully effective (July 1, 2020), given that the firms will need to manage the implementation of two significant changes at the same time and the interaction between the two is not yet clear.<sup>35</sup>

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<sup>34</sup> Vice Chairman for Supervision Randal K. Quarles, A New Chapter in Stress Testing, Speech at the Brookings Institute (Nov. 9, 2018).

<sup>35</sup> FRB Vice Chairman Quarles has stated that he does not expect SCB to go into effect before 2020. *See id.* In addition, uncertainty and volatility could be exacerbated further due to the upcoming transition from the London Inter-Bank Offered Rate (LIBOR) to the Secured Overnight Financing Rate (SOFR), which is referenced in many derivatives contracts.

Moreover, in addition to the inefficiencies that overlapping requirements generally introduce into the prudential framework, the interaction with the SCB has the practical impact of making it difficult for firms and their boards of directors to engage in capital planning. The Forum previously has noted the importance of predictability in the capital planning process and designing regulation so as not to introduce unnecessary volatility.<sup>36</sup> Without an explicit assessment of how SA-CCR would be implemented in the context of CCAR, it is not possible to assess how its adoption would contribute to volatility in the SCB.

*SA-CCR Calibration.* As discussed above, the Proposal does not explain how SA-CCR can be rationalized with current requirements or how SA-CCR would interact with contemplated changes. The primary effect of this lack of analysis is that the cumulative effect of these proposed regulations remains unclear and could result in a significant increase in capital requirements for GSIBs above current levels, which is likely to inhibit customers' ability (particularly commercial end users, as noted above) to manage risk efficiently.

Given the current levels of capital at the GSIBs and the vital role that the GSIBs play in facilitating commercial end users access to financial markets, the Agencies should consider revisiting the Basel Committee's calibration to the extent necessary to offset increases to overall capital requirements due to unforeseen interactions with the Agencies' other prudential regulations. As examples, below we highlight two specific issues with the proposed calibration of SA-CCR.

First, the Proposal asks whether the incorporation of the alpha factor supports the objective of "ensuring that SA-CCR produces more conservative exposures than [internal models]" and whether there are "alternative measures the agencies could incorporate into SA-CCR to support this objective."<sup>37</sup> Although the 1.4 alpha factor ensures that SA-CCR produces more conservative exposures than internal models, we believe that the 1.4 alpha factor may not be the most appropriate measure to achieve the Agencies' objective. In particular, the 1.4 alpha factor was calibrated before the regulatory finalization of significant derivatives markets reforms that followed the 2007-2008 financial crisis (*e.g.*, mandatory clearing requirements and swaps margin rules) and well before Basel III finalization in the United States, suggesting that the 1.4 alpha factor may not adequately take into consideration the ultimate impacts of those reforms.

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<sup>36</sup> See SCB Comment Letter from the Forum, dated June 25, 2018, [https://www.fsforum.com/wp-content/uploads/2018/06/forum\\_scb\\_comment\\_letter.pdf](https://www.fsforum.com/wp-content/uploads/2018/06/forum_scb_comment_letter.pdf). ("unpredictable and opaque stress testing model and scenario designs lead to volatility, and, therefore, ever larger capital buffers as firms seek to ensure they are able to avoid restrictions on their capital distributions. As a result of these dynamics, our boards of directors cannot meaningfully engage in the capital planning process.").

<sup>37</sup> Proposal at 64666 (Question 3).

Second, the Proposal asks a number of questions regarding the calibration of the components of the SA-CCR calculation, including with respect to the calculation of “adjusted notional amount”<sup>38</sup> and the supervisory factors for each asset class.<sup>39</sup> The Agencies should revisit the calibration of these various components of the SA-CCR calculation, including with respect to the supervisory duration calculation for interest rate derivatives (including to-be-announced securities (“TBA”))<sup>40</sup> and the supervisory factors for the equities and commodities asset classes. Moreover, the Agencies also should avoid “gold plating” and should calibrate the framework to result in capital requirements no higher than the Basel Committee’s standards. For example, in contrast to the Basel Committee’s SA-CCR framework, the Proposal does not provide separate supervisory factors for electricity and oil/gas components of the energy commodity class, instead assigning a single supervisory factor for an energy commodity class (based on the higher supervisory factor applicable to electricity derivatives).<sup>41</sup>

In light of the capital levels at our member institutions and the various other regulatory changes enumerated above, we believe the Proposal’s conservatism is not necessary. To address this unnecessary conservatism, the Agencies could offset any increases to overall capital requirements due to SA-CCR by adjusting the 1.4 alpha factor or other components of SA-CCR or, alternatively, by making changes to other parts of the regulatory capital framework (after conducting, and being informed by, the quantitative impact study recommended above).

***The SA-CCR Framework Should Be Used Consistently Throughout the Agencies’ Prudential Standards.*** While the Proposal contemplates interactions and conforming changes to certain of the Agencies’ other regulations, including single-counterparty credit limits, the supplementary leverage ratio, and the OCC’s lending limits, the Proposal is silent on whether the SA-CCR framework also would be used to measure counterparty credit risk exposure in other contexts. For example, the FDIC’s deposit insurance assessment methodology,<sup>42</sup> the FRB’s FR Y-15 form used to calculate GSIB indicator scores,<sup>43</sup> and the Agencies’ approaches to calculating CVA capital

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<sup>38</sup> Proposal at 64674 (Question 11).

<sup>39</sup> Proposal at 64676 (Question 12).

<sup>40</sup> As discussed in the ISDA letter, the supervisory duration calculation for interest rate swaps is likely to have a negative impact on the TBA market.

<sup>41</sup> Basel III SA-CCR at 19.

<sup>42</sup> 12 CFR pt. 327, subpt. A, App. A.

<sup>43</sup> FR Y-15 Instructions, Schedule A (Size), Line Item 1, Schedule B (Interconnectedness), Line Items 5, 11.

requirements<sup>44</sup> each refer to or rely on the CEM methodology to measure exposures arising from derivatives contracts. Similarly, the Agencies' swaps margin rule uses a CEM-like methodology to quantify initial margin requirements for non-cleared swaps and non-cleared security-based swaps.<sup>45</sup>

More broadly, the Agencies have not discussed whether and how the modeling and other assumptions implicit in the Proposal would be applied to the Agencies' other frameworks for measuring counterparty credit risk. For example, the Agencies do not reconcile the Proposal's bifurcation of exposure calculations for margined and unmargined trades<sup>46</sup> with other parts of the regulatory framework, including the FRB's determination of net stress losses under CCAR's LCPD component. In particular, CCAR currently requires firms to calculate the impact of a default of their largest single counterparty as part of the LCPD, but does not require firms to distinguish between margined and unmargined counterparties.<sup>47</sup> Consistency with the Proposal would suggest that the risk-mitigating benefits of variation margin should be reflected in the LCPD.

Indeed, derivatives subject to variation margin agreements are likely to result in lower losses than unmargined derivatives because: (1) exchange of variation margin minimizes the market risk between the time a counterparty fails to make variation margin payments (which triggers default rights) and the time it takes to cover the position; and (2) counterparties subject to variation margin agreements generally have access to greater amounts of liquid financial resources and are therefore more likely to result in higher recoveries (lower loss given default). Accordingly, to promote conceptual consistency with SA-CCR and to reflect the lower risk of margined transactions, the FRB should revise its application of the LCPD to allow firms to reflect the reduced losses associated with variation margin agreements.

Although we assume that the Agencies likely intend to revisit many of these other regulations in due course, we emphasize the need for uniformity and consistency across frameworks. The failure to implement the SA-CCR framework uniformly across the Agencies' prudential standards would result in a patchwork of methodologies, which inherently adds complexity and inefficiency that would not further any particular policy objective. Moreover, failure to apply consistent

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<sup>44</sup> See, e.g., 12 CFR 217.132(e)(5)(i)(C); 12 CFR 217.132(e)(6)(i)(B); 12 CFR 217.132(e)(6)(viii).

<sup>45</sup> 12 CFR pts. 45, 237, 349, subpt. A, App. A.

<sup>46</sup> SA-CCR provides different replacement cost and potential future exposure calculations for margined and unmargined trades. See Proposal at 64665 ("SA-CCR improves collateral recognition (e.g., by differentiating between margined and unmargined derivative contracts)"). We support this approach.

<sup>47</sup> See CCAR 2019 Instructions 7 (Feb. 2019).

assumptions across similar and related frameworks (*e.g.*, the general recognition that derivatives subject to variation margin agreements are lower risk) may have material impacts. Finally, retention of multiple frameworks for calculating counterparty credit exposure will require firms to maintain multiple information technology systems, which will create unnecessary inefficiencies. Consequently, the Agencies should conduct a comprehensive review of their regulations and adopt the SA-CCR framework uniformly wherever a standard quantifies counterparty credit risk exposures arising from derivatives contracts or else provide a compelling policy rationale for not doing so.

**Conclusion.** In sum, we support revisiting CEM. We also believe, however, that SA-CCR should be designed, calibrated, and adopted as part of a comprehensive and transparent evaluation of the Agencies' larger prudential capital framework, including contemplated changes. Specifically, we recommend that the Agencies:

- revise the Proposal to be consistent with the congressional determination to avoid unnecessary costs for commercial end users;
- conduct a quantitative impact study that broadly analyzes the regulatory capital framework, including contemplated changes, and calibrate SA-CCR and other requirements in light of the results of this study;
- make SA-CCR mandatorily effective no earlier than the Basel III Implementation Date, retaining the option for firms to early adopt SA-CCR once it has been calibrated and finalized; and
- conduct a comprehensive review of their regulations and implement the SA-CCR framework wherever the Agencies' standards quantify counterparty credit risk exposures arising from derivatives contracts. This review should include ensuring that the FRB's CCAR LCPD component recognizes the risk-reducing benefits of variation margin.

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Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Corporation  
Office of the Comptroller of the Currency 15

March 18, 2019

Thank you for considering these comments. Please feel free to contact the undersigned (KFromer@fsforum.com) with any questions.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Kevin Fromer". The signature is written in a cursive style with a long, sweeping underline.

Kevin Fromer  
President and CEO  
The Financial Services Forum

**Exhibit A**  
**Illustrative Impacts on Commercial End User Risk Management Transactions**

*Example 1: Commodity End User Hedge*

The table below illustrates a commodity derivative transaction with, for example, a electricity cooperative or airline that includes optionality.<sup>48</sup> The trade has a notional amount of approximately \$715 million, a replacement cost (“RC”) of approximately negative \$21 million (*i.e.*, a \$21 million liability in the customer’s favor) and a residual maturity of 0.98 years.

The potential future exposure (“PFE”) under CEM is approximately \$33.5 million (4.7% of the notional amount of the contract), compared to an alpha-adjusted PFE amount of approximately \$223.8 million under SA-CCR (31.3% of the notional amount of the contract and 39.2% of delta-adjusted notional). After taking into account the replacement cost, SA-CCR results in a 568 percent higher exposure amount compared to CEM for this illustrative transaction.

|                                | <b>CEM</b>     | <b>SA-CCR</b>  | <b>Percent Change</b> |
|--------------------------------|----------------|--|-----------------------|
| Notional                       | \$715,302,675  | \$715,302,675<br><br>\$570,649,929<br>(delta adjusted) <sup>49</sup> | -20%                  |
| PFE Amount<br>(alpha adjusted) | \$33,517,355   | \$223,837,717  | 568%                  |
| RC (alpha<br>adjusted)         | \$(21,283,154) | \$(21,283,154)   | 0%                    |
| Exposure Amount                | \$33,517,355   | \$223,837,717  | 568%                  |

<sup>48</sup> Hedging allows producers, such as an electricity cooperative, to stabilize cash flows, protect target returns on investments, reduce earnings volatility, reduce working capital requirements and enables customers to achieve budget targets. For producers, over-the-counter (“OTC”) hedging is preferable over exchange future hedging, because OTC hedging can be collateralized through a lien on assets instead of cash collateral, which would expose the producer to liquidity risk. For an end user, such as an airline, hedging allows the company to stabilize cash flows notwithstanding market movements in the price of a commodity (such as fuel).

<sup>49</sup> The delta of the option of 0.798 reflects a put option sold to the customer that is deeply in-the-money from the customer’s perspective.



*Example 2: Municipal Bond Derivative*

The table below illustrates a municipal bond derivative transaction with a municipality.<sup>50</sup> The trade has a \$162.5 million notional amount, an RC of approximately \$46.4 million and a residual maturity of 19 years.

The PFE under CEM is approximately \$2.4 million (1.5% of the notional amount of the contract), compared to an alpha-adjusted PFE amount<sup>51</sup> of approximately \$16.3 million under SA-CCR (10.1% of the notional amount of the contract). After taking into account the replacement cost, SA-CCR results in a 66 percent higher exposure amount compared to CEM for this illustrative transaction.

|                                | <b>CEM</b>    | <b>SA-CCR</b> | <b>Percent Change</b> |
|--------------------------------|---------------|---------------|-----------------------|
| Notional                       | \$162,500,000 | \$162,500,000 | 0%                    |
| PFE Amount<br>(alpha adjusted) | \$2,437,500   | \$16,348,816  | 571%                  |
| RC (alpha<br>adjusted)         | \$46,421,879  | \$64,990,630  | 40%                   |
| Exposure Amount                | \$48,859,379  | \$81,339,446  | 66%                   |

<sup>50</sup> Our member institutions enter into interest rate derivatives with large, highly-rated U.S. state and local governments. These end users primarily use swaps to hedge variable interest rate exposure associated with both publicly issued debt and private bank loans. The debt, loans and swaps are typically backed by a pledge of ad valorem taxing power. In many instances, government end users are precluded by statute from posting collateral, while other end users may only be required to post collateral when their public rating falls to a certain level.

<sup>51</sup> The relevant comparison is an alpha-adjusted PFE amount, because the 1.4 alpha factor is distributive to the PFE component.