## HOUSE AG SUBCOMMITTEE HEARING

## OVERVIEW

For questions please contact Kwon Park at (202) 547-3035.

Today, the House Ag Subcommittee on Commodity Exchanges, Energy, and Credit held a hearing "To Review the Impact of Capital and Margin Requirements on End-Users."

### Key Takeaways

- Three of the four witnesses implied that the Basel III leverage ratio's failure to recognize client margin posted to a bank-affiliated clearing member as segregated customer funds will put the G-20 goal of increased clearing in jeopardy and reduce end-users' access to derivatives markets.
- All four witnesses agreed that futures commission merchants (FCMs) were being consolidated by bigger organizations, but one witness disagreed as to the claim that end-users were being negatively impacted by consolidation.
- Scott O'Malia, CEO of ISDA, asked regulators to conduct a comprehensive cumulative impact assessment encompassing all elements of the bank capital and liquidity reforms before rules are implemented. He also asked the CFTC to finalize its cross-border rules to be consistent with the prudential rule and to reevaluate its cross-border guidance.

## SUMMARY

### Opening Statement and Testimony

**Subcommittee Chairman Austin Scott (R-GA)**

- While Congress has been explicit in its efforts to exempt end-users from much of the regulatory burdens associated with Dodd-Frank, these rules could have impacts on end-users if they drive intermediaries, like FCMs and swap dealers (SDs), from the markets.
- Today's hearing is not about the purpose or need for capital and margin standards – it is about the outsized consequences of small decisions made when designing these rules.
- Protecting end-users does not need to be a zero-sum game - we can build both resilient markets and protect end-users from unnecessary burdens.

**Subcommittee Ranking Member David Scott (D-GA)**

- We must find the right balance between high enough capital and margin requirement to keep the system safe and low enough to ensure the system is profitable for everyone in the industry.
- Farmers, ranchers, and manufacturers did absolutely nothing to cause the financial crisis – our Committee must make sure this spirit continues.
- If we do not solve the European Union (EU) cross-border equivalency issue, it will put U.S. end-users and clearinghouses at a very serious competitive disadvantage.

**Walter Lukken, President and CEO, Futures Industry Association (FIA)**

- Despite the expansion of the clearing requirement under Dodd-Frank and the European Market Infrastructure Regulation (EMIR), the clearing member community in the U.S. has decreased from 190 firms in 2004 to 55 firms today.
- The Basel III leverage ratio fails to properly recognize that client margin posted to a bank-affiliated clearing member belongs to the customer, and is provided by the customer to offset the bank's exposure of the clearinghouse.
- The amount of capital under the Basel leverage ratio required to be held for clearing is estimated to be between $32 billion and $66 billion – end-users are beginning to feel the impacts, which are likely to increase over time as Basel is fully implemented.
- Liquidity and portability of cleared derivatives markets could be significantly impaired by these capital rules, which would substantially increase systemic risk.
- Without a fix to recognize client margin as segregated under the leverage ratio, the G-20 goal to increase clearing will be in jeopardy and end-users will have less access to derivatives markets.

**Scott O'Malia, CEO, International Swaps and Derivatives Association (ISDA)**

- Regulators need to conduct a comprehensive cumulative impact assessment encompassing all elements of the bank capital and liquidity reforms.
- ISDA's analysis shows that regulatory impacts are not uniform across all banks – regulators should also assess regulatory impacts on individual business lines.
- According to analysis by the Fed and the CFTC, the industry may have to set aside over $300 billion in initial margin (IM) to meet the margin requirements on uncleared swaps.
- ISDA has developed a standard IM model called ISDA SIMM that all participants can use to calculate IM requirements, worked to draw up revised margin documentation compliant with the rules, and established a transparent and robust governance structure to allow for the necessary evolution of the model.
- As the deadline for implementation of IM requirements approaches for banks, regulators need to send a clear signal that ISDA SIMM is fit for application and the CFTC must finalize its cross-border margin rules to ensure substituted compliance determinations.
- The leverage ratio, in its current form, acts to disincentivize central clearing – working against a key objective of the G-20 derivatives reforms.

**Thomas C. Deas, Jr., National Association of Corporate Treasurers on behalf of the Center for Capital Markets Competitiveness and the Coalition for Derivatives End-Users**

- End-users comprise less than 10% of the volume in derivatives markets and use derivatives to hedge and offset business risks. Continuing uncertainty and the cumulative impact of these regulations are reducing the number of counterparties available to end-users, and leading to burdens for end-users.
- The Net Stable Funding Ratio (NSFR) costs will discourage dealer involvement in derivatives, reducing the number of counterparties and liquidity available for end-users.
- The supplemental leverage ratio does not permit a clearing member to receive credit for segregated customer margin posted, and this failure to recognize customer margin will lead to fewer banks willing to provide clearing services.
- European exemptions on risk capital charges and other regulations may create a competitive disadvantage to U.S. companies without an exemption.

**Tyler Gellasch, Founder, Myrtle Makena, LLC**

- Regulatory reforms are not having a negative impact on end-users as they do not actually apply to them.
- Regulators must be careful on granting any type of exemption on cross-border issues – it was the London trading desks of AIG that led to significant losses.

## Discussion

### Capital Regulations

*Scott (R-GA):* Why should farmers and ranchers be concerned about capital rules? *Lukken:* Many businesses clear through bank-affiliated FCMs in futures markets. Ag companies and other end-users pay more for clearing services and have less FCM access.

*Lucas (R-OK) and Davis (R-IL):* Impacts if client margin is not properly recognized (leverage ratio)? What is driving FCM consolidation? *Lukken:* Four bank-affiliated clearing members have already exited the business and some have decided to wait on a decision until the rules are finalized - end-users will have less access to clearing members. Fixed costs and regulations are causing FCM consolidation. More volume is needed to make this business profitable, so FCMs are either getting out of the business or looking for a merger; *Gellasch:* Consolidation is happening, but the actual cost of a trade is going down with better bid/ask spreads and lower implementation costs.

*Kelly (R-MS):* Why did G-20 call for margin and capital to reduce systemic risk? *Lukken:* The G-20 looked at how the futures markets reacted to the financial crisis and appreciated the ability to port client accounts from a failing institution to a healthy institution, allowing the market to function. G-20 encourages clearing and regulators should not tax clearing through capital rules.

### Cross-Border

*Scott (D-GA):* Is the EU discriminating against the U.S. by granting equivalence to other jurisdictions with similar regulatory regimes? Are EU cross-border decisions putting American businesses at a competitive disadvantage (ICE, CME, farmers, manufacturers, risk managers)? *Lukken:* A better process should be developed on cross-border issues. A tentative agreement on equivalence took years on the derivatives front, with no progress yet on securities clearinghouses. If U.S. rules are not recognized by the EU, U.S. banks and exchanges would be at a disadvantage and lead to less choices for customer access to the markets; *O'Malia:* Rules will not be identical but are designed to have the same outcomes. The CFTC must finalize its cross-border rules to be consistent with the prudential rule and the agency should reevaluate its cross-border guidance; *Deas:* U.S. companies competing against European companies with exemptions for derivatives capital requirements will put American firms and consumers at a competitive disadvantage.

*LaMalfa (R-CA):* Are outcomes-based cross-border rules a preferred approach? *O'Malia:* Yes, applying rules in a granular level will always lead to differences. International regulators will never trust each other's regimes and the industry will be confused. Also, the CFTC must implement a speedy and consistent global framework for margin.

*Davis (R-IL):* How far along is the EU, Japan, and Switzerland in implementing Basel III capital standards? *Lukken:* Rule revisions are out for public comment, and Europeans are thinking about going in their own direction by not taxing clearing through the leverage ratio as in the U.S. regime.

### Banks

*Scott (R-GA):* What drives a bank's capital allocation decisions? *O'Malia:* Capital rules such as the leverage ratio. Regulatory requirements are increasing and should be cumulatively assessed before implementation.

*Conaway (R-TX):* Thoughts on the use of internal bank models? *O'Malia:* Internal models were developed to be more risk sensitive - recent standards reduce the ability to use internal models. I think internal models should be used with increased transparency, benchmarks, and more regulatory input. A standard model is less risk sensitive and more conservative, requiring more capital. A one-size fits all requirement is not ideal for every situation.

*Kirkpatrick (D-AZ):* What happens when a market participant has insufficient capital? *O'Malia and Lukken:* Prudential regulators will insist they raise more capital to meet regulatory requirements.

**Rulemaking Process**

*Scott (R-GA):* Should margin and capital rulemakings move in tandem? Did the prudential regulators consult with hedgers on regulations to address end-user concerns? *O'Malia:* Capital rules are moving in tandem, but a cumulative impact study should be conducted before implementation of any rule. Margin will be phased in throughout the next four years; *Deas:* The Chamber of Commerce and the Coalition of Derivatives End-Users remain active in submitting comment letters to express concerns. There are no active two-way dialogues with the prudential regulators.

*Kelly (R-MS) and Davis (R-IL):* Should regulators conduct a cumulative impact study before implementing these rules? *O'Malia:* A cumulative impact study along with an assessment on individual businesses will be informative. The facts will only better inform regulatory decisions.