The Impact of the US Bank Capital Proposals on End-Users that Rely on Cleared Derivatives Markets

Report and Recommendations Prepared by the CFTC GMAC Global Market Structure Subcommittee

On July 27, 2023, the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) -together, the US bank regulators - proposed[1] the Basel III endgame proposal and, separately, the Federal Reserve also requested comment on a proposal that would make significant adjustments to the calculation of the global systemically important bank holding companies (GSIB) surcharge.

These proposed rules represent a comprehensive rewrite of the regulatory capital standards that the biggest US banks are subject to, and will impact every activity that these US banks engage in.

This report will focus specifically on the harmful impact of the pending proposals on the CFTC regulated derivatives markets. Specifically, the report will focus on how the proposed US bank capital rules will:

- reduce the capacity of US banks to offer clients access to derivatives markets;
- reduce liquidity in derivatives markets;
- increase the costs of hedging for end-users and, as a result, increase costs for their customers;
- disproportionately harm smaller end-users and non-public companies;
- increase systemic risk;
- create an unlevel playing field for market participants, including across jurisdictions.

The report will also highlight excerpts from the formal comment letters filed by the users of derivatives markets highlighting concerns about the proposals, including agriculture, energy, insurance, pension funds, and others. For examples, a joint letter[2] from nine agricultural trade associations highlights the important role of client clearing in removing counterparty risk and allowing end-users to trade contracts "without fear of loss if their counterparty defaults." The letter goes on to note that central clearing "has been a mainstay of the agricultural futures markets for more than a century, and its importance to financial stability and market functioning was validated by the G20 leaders in the aftermath of the financial crisis of 2008." The letter also notes that the "strength of central clearing depends, however, on the participation of banks and other institutions as members of clearinghouses. They provide the majority of the financial resources that support the clearing system, and they guarantee the performance of the trades they clear." Additionally, for example, The National Council of Farmer Cooperatives (NCFC) emphasize in their comment letter[3] that "America's farmers and ranchers must continue to have access to a diverse set of risk management products that enable them to feed, clothe and provide fuel to consumers here at home and around the world."

The report will also feature excerpts from exchanges and clearinghouses that provide the foundation of the well-functioning and highly regulated US derivatives markets.

[1] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm
[2] https://www.federalreserve.gov/SECRS/2024/January/20240112/R-1813/R-1813_121123_156411_319900252084_1.pdf
[3] https://www.fdic.gov/resources/regulations/federal-register-publications/2023/2023-regulatory-capital-rule-large-banking-organizations-3064-af29-c-191.pdf

It should be noted that the CFTC Global Market Risk Advisory Committee (GMAC) has included presentations and insightful discussions about the pending US bank capital proposals during the two prior meetings. In the November 2023 meeting[4], Jeremy Wodakow, the chief revenue officer of Cypress Creek Renewables, raised concerns that the pending bank capital rules "significantly raises the cost for banks to provide hedging services and funding to their clients, such as Cypress Creek, which will create additional headwinds to developing renewable energy projects." In the March 2024[5] meeting, Reggie Griffith, global chief compliance officer, Louis Dreyfus Co., and Dan Gallagher, director, commodity sales and trading, Basin Electric Power Cooperative (on behalf of the National Association of Rural Electric Cooperatives), raised significant concerns about the potential unintended consequences of the bank capital proposals on the futures markets and end-users that rely on them. These include concerns related to the ability to access futures and derivatives markets through bank FCMs as well as the increased costs for hedging and, ultimately, increased costs for consumers of agricultural and energy. Elisabeth Kirby, head of market structure, Tradeweb, raised concerns that the pending bank capital rules could have harmful effects on important financial markets, US market participants, and the US economy. Kirby said meaningfully higher capital requirements could reduce or eliminate the ability for certain banks to act as liquidity providers which would have the unintended consequence of reducing liquidity of the markets overall.

This report will build on the foundational work of the prior GMAC meetings to highlight the impact the pending bank capital proposals will have on the CFTC regulated markets and market participants.

At the outset of the report, CFTC Chairman Rostin Behnam should also be acknowledged for his comments in public testimony[6] before Congress in March 2024, emphasizing the need to "create incentives" for clearing committing to working with his prudential regulators to ensure new bank capital rules are not "creating unnecessary barriers to clearing and clearing services for end users." More recently, in April 2024, Chairman Behnam was quoted at an industry conference event stating "The general consensus among both the official sector and private sector is that clearing is good; it comes at tremendous benefit for market efficiency and reduction of systemic risk."[7]

Finally, it should be noted that these bank capital proposals cannot be considered in a vacuum. While outside of the CFTC's jurisdiction, the SEC recently adopted final rules that will require most market participants to clear repos they enter into on US Treasury securities as well as certain cash purchases and sales of Treasury securities. The implementation of these new clearing mandates will take place around the same time that the US bank capital requirements are expected to be implemented, with interrelated repercussions for market participants whose activities span across the derivatives and securities markets (such as in the case of market participants who seek to cross-margin their exposures across Treasury futures and cash securities transactions). As such, these rules must be considered together and, should the pending US bank capital rules be finalized as proposed, will contribute further to the capacity challenges for US GSIBs that offer client clearing services.

[4] https://www.cftc.gov/PressRoom/Events/opaeventgmac110623
[5] https://www.cftc.gov/PressRoom/Events/opaeventgmac030624
[6] https://agriculture.house.gov/calendar/eventsingle.aspx?EventID=7732
[7] https://www.risk.net/regulation/7959281/cftc-chair-backs-easing-of-g-sib-surcharge-in-basel-endgame

Estimated increase in capital requirements for derivatives transactions included in the US bank capital proposals

Capital Requirement Attributable to Six US GSIBs' Client Clearing Activity as of June 30, 2023[8]

	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%

Looking at just the six largest US banks that offer client clearing services, an independent data collection conducted by FIA and ISDA estimates that the Fed's GSIB Surcharge Proposal[9] and the joint-Basel III Endgame Proposal[10], combined, would increase their capital requirements for client clearing by more than 80%. These rules would make it far more expensive for banks to provide their clients with clearing services for futures, options, and OTC derivatives.

The Endgame Proposal's regulatory capital treatment of derivatives clearing activities would impose disproportionately high capital requirements on banks that offer client clearing services, including futures, options, and cleared OTC swaps, and disincentivize banking organizations from offering those services to clients. According to the FIA/ISDA QIS study, this Endgame Proposal alone would increase the capital required for six US GSIB firms to engage in their current scope of client clearing activities by more than 22%, or over $2.01 billion in the aggregate – the vast majority of this increase coming from the proposed Operational Risk and CVA Frameworks.

Recommendations to amend the bank capital proposals to promote client clearing

[8] *The FIA/ISDA 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.
[9] https://www.fia.org/fia/articles/fia-files-comment-letter-opposing-g-sib-surcharge-proposal
[10] https://www.fia.org/fia/articles/fia-strongly-opposes-basel-iii-endgame-proposal

Federal Reserve Board Chairman Jerome Powell has stated that global regulators "have a responsibility to ensure that bank capital standards and other policies do not unnecessarily discourage central clearing."[11]

CFTC Chairman Behnam, in remarks about the pending bank capital proposals, has publicly said "we want to incentivize clearing; we want to focus on understanding the benefits of it and not creating unnecessary costs that disincentive clearing."[12]

To accomplish this, and not disincentivize clearing, the pending bank capital proposals should be amended in the following ways.

The Federal Reserve's GSIB Surcharge Proposal should be amended to:

- remove the clearing member guarantee of client performance to a clearinghouse in a client cleared transaction in the agency clearing model from the Complexity and Interconnectedness indicators.

The US Bank Regulator's Basel III Endgame Proposal should be amended to:

- exempt client cleared derivatives from the CVA capital framework;
- avoid unduly penalizing client clearing services in the operational risk framework
- ensure highly-rated privately owned companies, pensions and mutual funds, are not unfairly harmed because the new proposed rules deem them riskier than their public counterparts;
- revise SA-CCR to permit netting certain STM and CTM transactions, which will increase in importance once the Treasury clearing mandates are finalized;
- withdraw the proposal's changes that would prohibit the decomposition of nonlinear instruments on indices within SA-CCR.

Reduced capacity of US banks to offer clients access to derivatives markets

Many derivatives are required to be cleared by law and most end users are not direct members of a clearinghouse. As such, they rely on "Futures Commission Merchants" (FCMs) – the majority of which are affiliates of bank holding companies - to facilitate their hedging needs.

According to December 2023 data from the CFTC, there were 47 registered FCMs providing customers with access to exchange traded derivatives markets, a roughly 50% decline during the past twenty years. Additionally, there are a limited number of banks that provide clearing services for over-the-counter (OTC) derivatives. When Dodd-Frank Act clearing mandates became effective in 2014, there were twenty-two FCMs providing OTC clearing. Today, there are only twelve clearing banks, with seven of these banks comprising 94% of the market. The top six of these banks are US GSIBs.

There are many reasons for this decline in the number of firms offering client clearing services, including increased capital requirements.

[11] Federal Reserve Board Governor Jerome H. Powell, Central Clearing and Liquidity, Speech at the Federal Reserve Bank of Chicago Symposium on Central Clearing, Chicago, Illinois (June 23, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm.

[12] https://www.risk.net/regulation/7959281/cftc-chair-backs-easing-of-g-sib-surcharge-in-basel-endgame

End-users that rely on access to hedging tools, like futures and other derivatives, have expressed concerns that the proposed bank capital rules will further reduce the number of clearing members thereby reducing the capacity of clearing members to offer access to derivatives markets.

In turn, this could impair access to these instruments by a wide range of companies and end-users that use derivatives to hedge their risks or manage their investments. These companies include agricultural businesses, energy producers and public utilities, manufacturing and transportation companies, mortgage lenders, insurance companies, and pension funds.

What are commenters saying?

- Agriculture Joint Trade Association Letter[13]
    - "We are very concerned that any contraction in the availability of clearing services will have a disproportionate impact on agricultural end users that are far outside the major financial centers, especially smaller entities such as grain elevators and family farms."
- The National Grain and Feed Association (NGFA)
    - "If the proposals are implemented as currently drafted, NGFA is concerned GSIBs will cease providing futures commission merchant (FCM) services...The FCM capacity GSIBs bring is necessary for hedging risk and we strongly urge the Board to modify the proposals to remove the impact on derivatives and risk management tools that end-users rely upon."
- The National Council of Farmer Cooperatives (NCFC)
    - Cites concerns that the proposals will result in "fewer banking organizations acting as FCMs to the agricultural industry and as swap dealers in commodity OTC derivative contracts, thereby reducing end-users' risk management options."
- Energy Joint Trade Association Letter[14]
    - Cites concerns that a result of the proposals being implemented "will be a decrease in entities offering clearing services."
- The State of Wisconsin Investment Board (SWIB) and the Ohio Public Employees Retirement System (OPERS)
    - Raises concerns that the Basel III Endgame Proposal "could reduce our options for generating efficient liquidity and prudently managing our risk, both of which are critical for mature pension funds like ours, as U.S. banking organizations exit lines of business they see as unprofitable."
- The Intercontinental Exchange (ICE)
    - Emphasizes concerns that the Basel III Endgame Proposal "could also further reduce the ability for U.S. bank affiliated clearing members to provide client clearing services due to increased capital requirements for such activities." ICE notes that "many clearing members have left the business over the past several years and a smaller clearing member community adversely impacts the financial markets by concentrating risk while reducing the availability of clearing services to end-users."
- The Options Clearing Corporation (OCC)

[13] The Agriculture Joint Trade Association Letter is signed by the following trade associations: The National Council of Farmer Cooperatives, the Commodity Markets Council, the National Cattlemen's Beef Association, the National Grain and Feed Association, the American Farm Bureau Federation, the National Milk Producers Federation, the National Pork Producers Council, the American Cotton Shippers Association, the Farm Credit Council
[14] The Energy Joint Trade Association Letter is signed by the following trade associations: The Energy Trading, the Institute Electric Power Supply Association, the American Gas Association, the American Public Gas Association, and the Commodity Markets Council

    - At a high level, OCC notes that "capital requirements in the Proposal that would disincentivize and reduce access to central clearing would run directly counter to the goal of promoting central clearing in financial markets that has long been supported by leading global economies, Congress, and U.S. financial regulators. Accordingly, OCC believes that it is critically important that any new capital requirements implemented by the Agencies do not disrupt or undermine continued access to central clearing."
- Cboe Global Markets (Cboe)
    - Highlights that "given the increasingly smaller universe of clearing members coupled with higher demand for clearing, the Agencies must ensure the methodologies used to calculate bank capital requirements not only appropriately measure risk exposures but strike a balance that allows for recognition of capital efficiencies to be maximized and, as a result, foster robust clearing capacity in the economy."
- Nodal Clear
    - Notes that under the GSIB Surcharge Proposal, "bank-affiliated clearing member's capital requirements would increase. As such, this will in turn limit the willingness of bank-affiliated clearing members to offer clearing services, thereby restricting choices for hedgers and escalating costs for end-users." As a result of both the Basel III Endgame Proposal and the GSIB Surcharge Proposal, Nodal believes banks will react by increasing fees for providing access to cleared derivatives markets or refusing to provide access to the bank's least profitable clients.

Reduced liquidity in derivatives markets

End-users of derivatives rely on access to deep, liquid, and well-functioning markets to manage risk. The bank capital proposals being considered today will substantially raise the amount of capital that US bank holding companies (BHCs) will need to hold to provide end-users access to derivatives markets.

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.

What are commenters saying?

- The National Council of Farmer Cooperatives (NCFC)
    - Cites concerns that the proposals will result in "less liquid and more volatile markets."
- Energy Joint Trade Association Letter
    - Cites concerns that a result of the proposals being implemented will be "a decrease in liquidity (which will increase volatility)."
- The State of Wisconsin Investment Board (SWIB) and the Ohio Public Employees Retirement System (OPERS)
    - Raises concerns that the Basel III Endgame Proposal may result in higher fees and lower spreads and "may naturally drive out some market participants – which will decrease liquidity for all investors and runs counter to the goals of the Proposal.
- Coalition for Derivatives End-Users
    - Highlights that the proposals "would lead to significant disruptions in the derivative markets, which would reduce market liquidity and efficiency, particularly during periods of stress, and increase transaction costs."

Increased costs of hedging for end-users and, as a result, their customers

The Proposals may incentivize some US GSIBs to raise prices for their clearing services, perhaps beyond the point where many end-users would find it uneconomical to use cleared derivatives to hedge their risks or to meet the clearing mandate. At the same time, it is not realistic to expect that many end-users would ever become direct members of a CCP, as the vast majority of clients are not financial institutions and thus are not equipped to manage the risks of being a clearing member, contribute to a CCP's default fund, or comply with all the rules and requirements that apply to clearing members.

Additionally, the Proposals further disincentivize hedging by increasing capital costs associated with cross-product margin arrangements. As drafted, the Proposals would remove cross-product netting sets from the definition of a "netting set" and limit "netting sets" to groups of single-product transactions that satisfy certain requirements.[15] The practical effect of this non-recognition is that it will not be possible for US GSIBs to recognize the beneficial risk offsets that arise from cross-product margining arrangements (and the hedging benefits that are seen in these relationships). Ultimately, the capital requirements applicable to a portfolio of hedged transactions in a cross-product margining arrangement will be misaligned with the risks that the portfolio actually presents.

What are commenters saying?

- The National Grain and Feed Association (NGFA)
    - "NGFA has concerns that the proposals will result in increased costs for accessing cleared derivatives markets."
- The National Council of Farmer Cooperatives (NCFC)
    - Cites concerns that the proposals will result in "increased end-users' costs of hedging."
- Energy Joint Trade Association Letter
    - Raises concerns that the proposals "will make it more expensive for banks to offer clearing to their customers" and that "although these proposals are not aimed directly at end-users, we believe that the indirect effects will be substantial. This could make hedging unaffordable for many energy end-users, which would expose them to higher risks. Alternatively, if end-users decide to pay more to hedge, the costs will flow through to their customers in the form of higher energy prices."
- The American Council on Renewable Energy
    - While much of the letter cites the impacts of revised risk weights for the renewable energy tax equity market, the letter cites other issues "that could substantially impact investment in and support for renewable energy initiatives more broadly" including "the new framework for market risk proposals and the additive requirements for derivative transactions." The letter explains that these provisions "could significantly raise the costs for U.S. companies to hedge their business and operating risks."
- The National Association of Manufacturers
    - The letter highlights concerns that the Basel III Endgame Proposal includes a "substantial increase in capital requirements for banks' trading books through the Fundamental Review of the Trading Book" which "will significantly increase the costs of critical risk management tools for U.S. manufacturers." The letter goes on to state that "end-users such as manufacturers will be impacted with higher pricing and decreased availability of hedging tools."
- The American Council of Life Insurers (ACLI)
    - Highlight concerns that the Basel III Endgame Proposal "would unnecessarily lead to excessive bank capital requirements and increase costs for life insurance hedging transactions, which help insurers manage market-based risks in investment portfolios and products that deliver financial security to millions of Americans."
- The State of Wisconsin Investment Board (SWIB) and the Ohio Public Employees Retirement System (OPERS)

[15] https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant at p. 64059.

    - Raises concerns that the Basel III Endgame Proposal "would negatively, and in some cases, disparately, impact public pension funds by increasing costs and obstructing access to necessary financial services."
- Coalition for Derivatives End-Users
    - The Coalition raises significant concerns about major aspects of the proposals noting that "commercial end-users face material increases in hedging costs, disincentivizing prudent risk-management by corporations and ultimately increasing risk and reducing investment in our economy."
- Business Roundtable
    - Business Roundtable raises concerns that the new framework for market risk and the new additive requirements for derivative transactions "would significantly raise the costs for U.S. public companies to hedge business and operating risks (*e.g.*, interest rate, foreign exchange and commodity risks)." In the face of higher costs, Business Roundtable raises concerns that "companies may: (i) hedge less or, if hedging becomes cost-prohibitive, not at all, with the Proposal having the perverse effect of making America's companies and, by extension, the broader U.S. economy, less financially resilient; (ii) internalize the costs, which would reduce earnings and restrict their ability to innovate, hire, grow and invest; or (iii) pass these costs to customers by raising prices on goods and services."
- The Depository Trust & Clearing Corporation and the Fixed Income Clearing Corporation
    - Raises the concerns that banking organizations, and potentially their clients in the future (subject to regulatory approval in the particular case of the FICC-CME cross-margining arrangement), will be unable to hedge with great effectiveness many of the particular risks the Proposals are seeking to address, including interest rate risk. In addition, overall market liquidity and stability reduces when cross-margining is reduced.

<u>Disproportionately harms smaller end-users and non-public companies</u>

The public listing requirement for investment grade entities, included in the Basel III Endgame Proposal, would make a corporate counterparty obligor eligible for the lower risk weight of 65 percent when the obligor is "investment grade" and has a class of publicly traded security outstanding (or is controlled by a company that does). While the requirement for the obligor to be publicly traded to be eligible for this lower risk weight would have general application across several banking business lines, it would have a disproportionately negative impact on the derivatives clearing business and for specific categories of customers that use derivatives to hedge their risks and are highly creditworthy but are not publicly traded.

This public listing requirement unfairly penalizes highly-rated privately owned companies, pensions and mutual funds because the new rules deem them riskier than their public counterparts. Also worth noting, the public listing requirement is not something that has been implemented in Europe.

Similar to the public listing requirement, Europe has diverged from the Basel standard for implementation of the credit valuation adjustment (CVA) framework. The capital for CVA is meant to capture the potential deterioration in the market value of derivatives to account for counterparty credit risk. The Basel III Endgame Proposal provides an exclusion for the calculation of CVA as it pertains to the CCP-facing leg of a trade cleared through a CCP but there is no such exclusion for the client-facing leg. A bank does not have actual CVA exposure when it acts as a clearing member on behalf of a client on a cleared trade and only incurs a loss if the client were to default with a shortfall that could not be covered by the client's collateral. Moreover, this default risk is already captured in other parts of the capital framework, so it is duplicative to have additional capital requirements for CVA for the client-facing leg of a cleared transaction.

What are commenters saying?

- The National Council of Farmer Cooperatives (NCFC)
  - Cites concerns that "unnecessarily high capital requirements that do not match the associated risk also will create a barrier to entry for certain market participants, such as farmer-owned cooperatives" and highlights concerns cooperatives will be "put at a disadvantage to other entities by being subjected to more expensive, and likely fewer options in access the derivatives markets to hedge their own commercial risks."
- The American Public Power Association (APPA) and National Rural Electric Cooperative Association (NRECA)
  - Cites concerns that because their members "are not publicly traded, large bank counterparties would face increased capital requirements" for certain transactions "simply because the bank's counterparty happens to be a cooperative or a government-owned entity. In turn, large banks will be less willing to participate in such transactions or, at a minimum, increase the charges for participating in such transactions to cover the additional costs imposed by the more stringent capital requirements."
  - The letter concludes that "if the proposal's bias against non-public traded companies, cooperatives, and government-owned entities is left intact, we believe it will severely and needlessly disrupt the ability of our Joint Association members to participate in risk management hedging transactions with large banks."
- The National Association of Manufacturers
  - Cites concerns that the proposals "would harm smaller manufacturers who…do not have publicly traded securities, and manufacturers who rely on banks to help them manage financial risks."
- The American Council of Life Insurers (ACLI)
  - Highlight concerns that the Basel III Endgame Proposal "includes a corporate exposures provision that would arbitrarily and baselessly discriminate against non-publicly traded life insurers."
- The California Public Employees' Retirement System (CalPERS)
  - Cites concerns that the Basel III Endgame Proposal "would punish CalPERS – and its two million beneficiaries – because it does not issue publicly traded debt securities."
- The State of Wisconsin Investment Board (SWIB) and the Ohio Public Employees Retirement System (OPERS)
  - Notes that it is important "to consider the harm that will result from assigning less favorable risk weights to entities like public pension funds that do not issue publicly traded securities." Ultimately, they raise concerns that "banking organizations, acting on their own balance sheet management concerns, will be incentivized to prioritize counterparties with more favorable risk weights over those with less favorable weights, which will put us at a disadvantage relative to other investors."

Increased systemic risk

Central clearing helps to mitigate systemic risk and provides transparency to end-users and market participants by replacing the complex web of bilateral ties between market participants with a more transparent central counterparty (CCP). Widespread central clearing is, however, only possible with FCMs that provide access to clearing for customers.

Central clearing also reduces systemic risk by facilitating the transfer (or "port") of the positions (and collateral) of a defaulting clearing member's client positions and assets to other, financially sound clearing members in a simple and rapid manner, with the goal of preserving the end-users' positions while protecting any collateral pledged.

According to the public quantitative disclosure of SwapClear, the 93.4% of client transactions are attributable to the top ten clearing members on average (peak is 98%)[16]. Should one of these 10 clearing members default, the remaining large clearing members would have to absorb around 10% of the clearing market. This is a big undertaking and very unlikely to happen if the proposed capital rules are in effect.

ISDA has in 2023 published a whitepaper "Addressing Porting Challenges"[17] that identifies lacking clearing capacity driven by capital requirements as one obstacle to successful porting of clients. These challenges would undoubtedly be intensified and more harmful during times of stress, such as during the Russian invasion of Ukraine when hedging needs intensified.

As noted by Federal Reserve Board Chair Jerome Powell, "[c]entral clearing serves to address many of the weaknesses exposed during the crisis by fostering a reduction in risk exposures through multilateral netting and daily margin requirements as well as greater transparency through enhanced reporting requirements. Central clearing also enables a reduction in the potential cost of counterparty default by facilitating the orderly liquidation of a defaulting member's positions, and the sharing of risk among members of the CCP through some mutualization of the costs of such a default."[18]

Excessive capital requirements on derivatives clearing businesses will increase systemic risk by requiring BHC FCMs to increase the costs for client clearing services beyond the point where end-users will find it economical to use cleared derivatives to hedge their risks. End-users may respond by going unhedged, which could increase risk in the financial system. Should end-users decide to pay higher prices, they will have fewer resources to invest in their businesses or they will be forced to pass additional costs on to clients and customers. Second, some banks are becoming disincentivized from offering clearing services altogether, and could limit access to cleared derivatives markets or exit the business entirely.

A reduction in the number of firms willing to serve as clearing members – and to increase their volume of clearing activity, if needed – could increase systemic risk because porting depends on the presence of a number of clearing members with capacity and willingness to take on additional clients from a failing clearing member in a rapid manner.

What are commenters saying?

- Agriculture Joint Trade Association Letter
    - "Central clearing reduces counterparty risk and allows end-users to trade these contracts without fear of loss if their counterparty defaults. Central clearing has been a mainstay of the agricultural futures markets for more than a century, and its importance to financial stability and market functioning was validated by the G20 leaders in the aftermath of the financial crisis of 2008. The strength of central clearing depends, however, on the participation of banks and other institutions as members of clearinghouses. They provide the majority of the financial resources that support the clearing system, and they guarantee the performance of the trades they clear."
- Energy Joint Trade Association Letter
    - Highlights that "central clearing provides the foundation for risk transfer in the energy derivatives markets, and by extension, the hedging strategies used by energy producers,

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[16] See https://www.lch.com/system/files/media_root/LTD_CCP12_PQD_Q4-2023.xlsx

[17] See https://www.isda.org/2023/10/10/addressing-porting-challenges/

[18] Federal Reserve Board Governor Jerome H. Powell, Central Clearing and Liquidity, Speech at the Federal Reserve Bank of Chicago Symposium on Central Clearing, Chicago, Illinois (June 23, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm.

refiners and suppliers to protect their businesses from price volatility." The letter goes on to raise concerns that the increased costs associated with the proposals

- The National Association of Manufacturers
    - Emphasizes that although the Basel III Endgame Proposal "revisions to the capital requirements for banks' trading books are intended to make the financial system safer and reduce risks to financial stability," in practice "these changes will undermine risk management in the broader economy." The letter goes on to state that the proposal fails to consider how proposal "would impact risk management by banks' customers" and raises concerns that "by making it less affordable and more complex for manufacturers and other non-bank entities to manage risks," the proposal "will ultimately make the U.S. economy less resilient and more vulnerable to financial shocks."
- The Intercontinental Exchange (ICE)
    - Emphasizes concerns that the "increased capital requirements in the Proposal may also increase systemic risk by lowering the probability of the successful porting of solvent customers of a defaulting clearing member of a CCP."
- The London Stock Exchange Group (LSEG)
    - States that the proposals "should not increase systemic risk by constraining banks' capacity for offering access to clearing, increase the cost for end users, or by otherwise disincentivizing the use of cleared derivatives." LSEG raises concerns, however, that "as the GSIB Surcharge Proposal would significantly increase clearing brokers' capital requirements, we are greatly concerned it will reduce the willingness of clearing brokers to accept new client positions and facilitate client porting."

Creates an Unlevel Playing Field Including Across Jurisdictions

The US bank capital proposals would impose significantly higher capital requirements than the international standard, as well as what is being implemented in the EU and UK. This would needlessly place US GSIBs and US clearing member banks at a disadvantage to their competitors, including those based abroad, which could shift clearing activity to institutions that are not subjected to the same capital rules.

Examples where US proposals have diverged from EU and UK rules:

- Inclusion of the clearing member guarantee of client performance to a clearinghouse in a client cleared OTC transaction in the agency clearing model in the Complexity and Interconnectedness indicators.
- Inclusion of client cleared transactions in the CVA framework.
- Requiring an entity be publicly listed to be considered investment grade and receive a lower risk weight.

What are commenters saying?

- The CME Group
    - Highlights aspects of the proposal where there isn't international consistency, for example in the GSIB Surcharge Proposal, noting that "inconsistent regulatory standards could impair the health of the U.S. derivatives market and broader financial system by reducing participation in central clearing."
- The Intercontinental Exchange (ICE)
    - Notes that the Basel III Endgame Proposal "would negatively impact the ability of U.S. banks to compete with their European counterparts" highlighting that it "deviates from the Basel committee framework and is more restrictive than legislation implemented in other jurisdictions creating competitiveness concerns for U.S. banks."
- The London Stock Exchange Group (LSEG)

- Highlights concerns that "any divergence from international standards would create a competitive disadvantage for U.S. GSIBs that provide client clearing in a "well capitalized" and highly regulated manner."

Conclusion

The CFTC regulated derivatives markets will be substantially impacted by the pending US bank capital proposal, including reduced access to derivatives markets for end users and further concentration of FCMs, should the proposals be adopted in their current form. This report has been developed to highlight many concerns raised about the proposals by commenters that represent end-user organizations, as well as exchanges and clearinghouses. The report highlights concerns that the pending bank capital proposals will increase the cost client clearing and hedging for market participants, which would disincentivize prudent risk management and increase risk in our markets.

GMAC urges the Commission:

- to continue engaging with the relevant US bank regulators about the pending proposals and the impact they will have on the markets that fall under the CFTC jurisdiction;
- to conduct an independent study of the proposals to better understand the impact of the proposals, should they be adopted in their current form, on the users of derivatives markets; and
- organize a roundtable with US bank regulators focused on derivatives markets.

Appendix

Broad Sampling of Public Comment Letters Highlighting Concerns w/the US Bank Capital Proposals

Agriculture

- Agriculture Joint Trade Association Letter
- The National Grain and Feed Association (NGFA)
- The National Council of Farmer Cooperatives (NCFC)

Energy

- Energy Joint Trade Association Letter
- The American Public Power Association and National Rural Electric Cooperative Association
- The American Council on Renewable Energy
- The National Public Gas Agency
- Huntsville Utilities
- Memphis Light, Gas and Water Division (MLGW)
- Community Choice Aggregators (CCAs)
- Arena Energy, LLC

General End-Users

- Coalition for Derivatives End-Users
- Business Roundtable

Risk Management Advisors

- AEGIS Hedging Solutions

Manufacturing

- The National Association of Manufacturers
- Kaiser Aluminum Corporation

Insurance

- The American Council of Life Insurers (ACLI)

Pension Funds and Investment Management

- The California Public Employees' Retirement System (CalPERS)
- The State of Wisconsin Investment Board (SWIB) and the Ohio Public Employees Retirement System (OPERS)
- BlackRock
- The American Benefits Council
- The Investment Association (IA)
- The Dutch Federation of Pension Funds

Exchanges and Clearinghouses

- The World Federation of Exchanges (WFE)
- The Global Association of Central Counterparties (CCP Global)
- CME Group
- Intercontinental Exchange (ICE)
- The Options Clearing Corporation (OCC)
- Cboe Global Markets
- The London Stock Exchange Group (LSEG)
- Nodal Clear
- The Depository Trust & Clearing Corporation