MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

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PRESIDENT & CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing
To Review Legislative Proposals Regarding Derivatives

BEFORE THE

U.S. HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES & INVESTMENT

FEBRUARY 14, 2018

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WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION

To Review Legislative Proposals Regarding Derivatives
February 14, 2018

Chairman Huizenga, Ranking Member Maloney, I am Richard Baker, President & Chief Executive Officer of the Managed Funds Association ("**MFA**"). I am pleased to provide this statement on behalf of MFA to present our members' views on one of the legislative proposals regarding derivatives that are the focus of today's important hearing. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices for hedge funds, funds of funds, managed futures funds, and service providers. MFA's members manage a substantial portion of the approximately $3 trillion invested in hedge funds around the world. Our members serve pensions, university endowments, and other institutions.

MFA's members are among the most sophisticated investors and play an important role in our financial system. They are active participants in the commodity and securities markets, including over-the-counter ("**OTC**") derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Hedge fund managers are fiduciaries that invest funds on behalf of institutional and high-net worth investors. Our members' skills help their customers plan for retirement, honor pension obligations, and fund scholarships, among other important goals.

As part of their asset management strategies, MFA members are active participants in the derivatives markets, and have consistently supported reforms to the OTC derivatives markets in Title VII ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") that mitigate systemic risk, increase transparency, and promote an open, competitive, and level playing field. The implementation of central clearing was a central goal of the 2009 G-20 commitments and the U.S. has been at the forefront of the move to central clearing. Clearing provides many benefits to the derivatives markets, including improved market liquidity and market integrity. We also have been a consistent supporter of the European Market Infrastructure Regulation, or EMIR, to ensure that European markets have similar benefits of central clearing of derivatives. As active participants in the U.S. markets for OTC derivatives, we would like to work with the G-20 countries, Congress, the Committee, the U.S. Prudential Regulators, the Basel Committee on Banking Supervision ("**Basel Committee**"), and all other interested parties to further the optimal implementation of derivatives clearing and bank capital and margin rules, which will reduce systemic risk, ensure affordable and impartial access to our financial markets, and strengthen our Nation's economy.

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As a result, MFA strongly supports H.R. 4659, bipartisan legislation to require the appropriate Federal banking agencies to recognize the exposure-reducing nature of client margin for cleared derivatives. We commend the bipartisan cosponsors of this measure, including Representative Luetkemeyer, Representative Lucas, and Representative David Scott for this thoughtful approach. We believe that the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System ("**Federal Reserve**"), and the Comptroller of the Currency (collectively, "**U.S. Prudential Regulators**") should modify their treatment of initial margin for centrally cleared derivatives for purposes of the U.S. Supplementary Leverage Ratio ("**SLR**"), including the enhanced SLR ("**eSLR**") for U.S. global systemically important banks ("**G-SIBs**"), to ensure that central clearing remains accessible and affordable for customers.

ENSURING THE ACCESSIBILITY AND AFFORDABILITY OF CUSTOMER CLEARING

Customers are a vital part of the derivatives markets and have been critical to the success of central clearing in the U.S. While some clearing of swaps between dealers existed prior to enactment of the Dodd-Frank Act, artificial barriers to entry prevented customers as clients of dealers from similarly participating in the cleared swaps market. Title VII's mandates requiring central clearing eliminated many of those artificial barriers and resulted in substantial dealer and customer clearing of derivatives.

MFA opposes the current formulation of the SLR because it undermines derivatives clearing and therefore is at cross purposes with Title VII. The SLR does not consider initial margin ("**IM**") that our members post with their respective clearing firms as a risk mitigant. Accordingly, the capital rules force the clearing firm to hold capital against such margin as if it were a conventional liability. The eSLR's additional capital buffer imposed on U.S. G-SIBs exacerbates this adverse effect by raising further the cost of clearing with resulting unintended adverse consequences that undermine systemic risk reduction. MFA echoes the call in the Banking Treasury Report and the Capital Markets Treasury Report for recommended adjustments to the SLR to address such unfavorable impacts caused by high leverage ratio capital charges.[1]

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[1] *See* U.S. Department of the Treasury Report to President Donald J. Trump in response to Executive Order 13772 on Core Principles for Regulating the United States Financial System, "A Financial System That Creates Economic Opportunities, Banks and Credit Unions", June 2017 ("**Banking Treasury Report**"), at pp. 54 and 126, *available at*: https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf. *See also* U.S. Department of the Treasury Report to President Donald J. Trump in response to Executive Order 13772 on Core Principles for Regulating the United States Financial System, "A Financial System That Creates Economic Opportunities, Capital Markets", October 2017 ("**Capital Markets Treasury Report**"), at pp. 138 and 215, *available at* : https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

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Prudential requirements that inflate the economic risk of derivatives, particularly the SLR, impose artificial barriers for asset managers' clients to access cleared derivatives and work at cross-purposes with mandates to clear. Recognizing these effects, Federal Reserve Board Member Jerome H. Powell recently stated that "[g]lobal authorities . . . have a responsibility to ensure that bank capital standards and other policies do not unnecessarily discourage central clearing."[2]

At present, swaps customers exclusively access central counterparties ("**CCPs**") indirectly through clearing members, rather than becoming direct members of CCPs, for a variety of reasons, both financial and operational. MFA anticipates that the demand for clearing services will increase as regulators in different jurisdictions fully implement their respective mandatory clearing initiatives.[3] As a result, it is critical that customer clearing services remain available at an affordable price to ensure that customers have fair and equal access to CCPs.

MFA's request for recalibration of the SLR is premised on the fact that CCPs' risk management methodologies are predicated on the collection of IM and variation margin from clearing members and customers to collateralize potential exposure. In addition, direct clearing members guarantee payment of their customers' obligations to the CCP. Because the IM is the customer's money,[4] rules adopted by the CFTC require clearing members to segregate customer funds from the clearing member's own assets.

While the leverage ratio framework captures a clearing member's guarantee to the CCP as an off-balance sheet exposure, leverage ratio rules fail to provide an offset that recognizes the exposure-reducing effect of customer IM for cleared derivatives. In the U.S., segregation rules severely restrict the ability of IM to be held in anything other than extremely low-risk and extremely liquid assets, assuring that it is always available to

[2] Remarks by then Federal Reserve Governor Jerome H. Powell at the Federal Reserve Bank of Chicago Symposium on Central Clearing, *Central Clearing and Liquidity*, at p. 3 (June 23, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/files/powell20170623a.pdf. Mr. Powell made these comments before he became Chairman of the Federal Reserve.

[3] For example, mandatory central clearing of certain OTC derivatives began in the EU in mid-2016. In addition, central clearing has already begun in Australia and Mexico, and is expected to begin soon in other countries, including Canada, Hong Kong, Singapore, and Switzerland. Notably, in light of these global developments, the Commodity Futures Trading Commission ("**CFTC**") has finalized rules that will expand the central clearing requirement in the U.S. to harmonize with these foreign jurisdictions. *See* CFTC final rule on "Clearing Requirement Determination under Section 2(h) of the CEA for Interest Rate Swaps", *available at*: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-23983a.pdf.

[4] Under CFTC rules, a clearing member must separately account for, and segregate as belonging to the customer, all money, securities and property it receives from a customer as margin. *See* 17 C.F.R. §§ 1.20-1.30; 17 C.F.R. §§ 22.2-22.7.

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absorb losses ahead of the bank.[5] Moreover, the substantial majority of segregated customer IM is posted to the CCP, and therefore, is entirely outside the control of the clearing member.[6]

The current failure of the SLR to recognize the purpose and exposure-reducing nature of customer IM is a threat to the use of cleared derivatives by customers. Because of the lack of offset for customer IM, clearing members will incur large leverage ratio exposures, which will likely raise prices for customer clearing significantly. This substantial cost increase may cause customers to reduce their hedging activities to levels that are inadequate to manage their risk, which could result in price increases and volatility for food, gasoline, and other consumer goods.

MFA notes that, on November 23, 2016, the European Commission proposed changes to the EU capital requirement regulation and directive that would, among other things, allow clearing firms to reduce the leverage ratio exposure measure by the IM received from clients for cleared derivatives.[7] MFA applauds this European Commission proposal.

Therefore, to ensure the continued affordability and robustness of customer clearing in the U.S., MFA respectfully requests that the Committee encourage the U.S. Prudential Regulators to consider the EC's proposal and industry-wide concerns in their rulemaking processes, and provide an offset for clearing members to the extent that customer IM is posted to the CCP, or is segregated under the U.S. regulatory regime. MFA emphasizes that our recalibration request is consistent with the recommendation of the Treasury Department in the Banking and Capital Markets Treasury Reports[8] and with remarks by Federal Reserve Governor Powell at its Global Finance Forum in Washington, D.C. on April 20, 2017, who called for recalibration of the SLR in the U.S. due to its damaging impact on client clearing.

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5 In the United States, segregated margin cannot be reinvested except for investments in low-risk and highly liquid assets, such as U.S. government securities, managed "with the objectives of preserving principal and maintaining liquidity". *See* 17 C.F.R. § 1.25(b).

6 Applicable U.S. margin and CCP regulations result in a significant majority of margin being passed onto the CCP. Although margin rules vary across jurisdictions outside of the U.S., non-U.S. margin frameworks for centrally cleared derivatives generally result in a substantial portion of margin held at the CCP rather than the clearing member.

7 *Available at*: https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF. Paragraph (11) at p. 26 states: "A leverage ratio should also not undermine the provision of central clearing services by institutions to clients. Therefore, the initial margins on centrally cleared derivative transactions received by institutions in cash from their clients and that they pass on to central counterparties (CCP), should be excluded from the leverage ratio exposure measure".

8 *See supra* note 1, Banking Treasury Report at p. 126 (recommending "significant adjustments" to the supplementary leverage ratio and a deduction from the leverage exposure denominator for IM for centrally cleared derivatives). *See also supra* note 1, Capital Markets Treasury Report at p. 215 (reiterating the Banking Treasury Report recommendation).

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H.R. 4659 addresses these concerns, amending the relevant banking statutes by directing the U.S. Prudential Regulators to ensure that any leverage-based bank capital rule, guideline, standard, or requirement deducts the amount of client initial margin for centrally cleared derivatives from the amount of leverage exposure arising from a banking organization's guarantee of a client's derivative obligation to the CCP. This provision will further the policy goals of supporting derivatives clearing and reducing systemic risk. At the same time, we believe that the bill's requirements will not in any way raise risks to banks or add to systemic risk. Finally, this legislation would be consistent with the European Commission's similar recommendations, thereby ensuring a level playing field between U.S. and EU clearing requirements.

CONCLUSION

MFA appreciates the Committee's review of the legislative proposals for derivatives. MFA's is strongly supportive of H.R. 4659. As discussed, we respectfully ask Congress to encourage the U.S. Prudential Regulators to modify the U.S. Supplementary Leverage Ratio to ensure that central clearing remains accessible and affordable for customers by providing a deduction in the SLR for customer initial margin. We believe that, by promoting, rather than discouraging, central clearing in the OTC derivatives markets, this modification will advance the G-20's and Congress's goal of reducing systemic risk in the derivatives markets.

MFA is committed to working with Members and staff of Congress, the Committee, regulators, and all interested parties to reduce systemic risk, ensure affordable and impartial access to our financial markets, and strengthen our Nation's economy.

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