



September 7, 2018

Via E-Mail:

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002, Basel
Switzerland

Re: Managed Funds Association Comments on Consultation on Incentives to Centrally Clear Over-the-Counter Derivatives

Dear Ladies and Gentlemen:

Managed Funds Association (“MFA”)¹ welcomes the opportunity to provide comments in response to the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures, the Financial Stability Board and the International Organization of Securities Commissions (together, “the Committees”) consultation on incentives to centrally clear over-the-counter (OTC) derivatives. MFA supports central clearing and our members are substantial users of central counterparty (“CCP” or “Clearing House”) clearing services for both exchange-traded and cleared OTC derivative contracts. We remain concerned that prudential requirements that inflate the economic risk of derivatives, particularly the leverage ratio, impose artificial barriers for clients to access cleared derivatives and work at cross-purposes with mandates to clear.²

We believe that the findings of the Derivatives Assessment Team’s (“DAT”), as set out in the Committees’ consultation report substantiate these concerns, in particular with respect to the treatment of initial margin (“IM”) under the leverage ratio. Based in part on the findings of the DAT assessment, the consultation paper states that further consideration of the treatment of initial margin in the leverage ratio “may merit consideration.” In light of the substantiated concerns regarding the negative impact of the treatment of initial margin, we encourage the Committees to adopt a stronger recommendation that relevant standard

¹ Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

² We note that the concerns expressed in this letter with respect to the leverage ratio also apply to the supplementary leverage ratio and enhanced supplementary leverage ratio rules in the United States.

setting bodies and national regulators modify the leverage ratio to address the identified concerns.

This recommendation would better align the consultation report with actions and statements of key policy makers and regulators regarding the treatment of IM under the leverage ratio. In that regard, 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.³ We further note the U.S. Treasury Department's recommendation in its October 2017 Capital Markets Report (the "Treasury Report") to transition regulatory capital requirements from the Current Exposure Method ("CEM") to an adjusted Standardized Approach for Measuring Counterparty Credit Risk Exposures ("SA-CCR") method, with offsets for client IM, to more accurately capture exposures that clearing members face when providing clearing services to clients.⁴ Similarly, then U.S. Federal Reserve Board Governor and current U.S. Federal Reserve Board Chairman 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."⁵ Also in the United States, policy makers are taking action to avoid these effects by proposing legislation that would adjust the supplementary leverage ratio rules in the United States.⁶

Accordingly, MFA encourages the Committees and regulators to modify the leverage ratio to recognize the exposure-reducing nature of client IM for cleared derivatives. We further encourage the Committees and regulators to reconsider the rules for IM on uncleared derivatives, which we believe have a punitive and disproportionate effect on buy-side market participants, particularly those market participants who trade non-clearable total return swaps ("TRS") and collateralize them based on the actual risk posed by such products. Set out below are our responses on relevant questions from consultation paper with respect to these issues.

³ 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".

⁴ 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, Capital Markets", October 2017, at pp. 138 and 215, available at : <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>.

⁵ Remarks by U.S. Federal Reserve Board Governor Jerome H. Powell at the Federal Reserve Bank of Chicago Symposium on Central Clearing, Central Clearing and Liquidity, at p. 4 (June 23, 2017), available at <https://www.federalreserve.gov/newsevents/speech/files/powell20170623a.pdf>.

⁶ On March 21, 2018, the U.S. House Financial Services Committee voted to advance a group of financial services bills, including H.R. 4659, a bipartisan measure that would require the appropriate Federal banking agencies to recognize the exposure-reducing nature of client IM for cleared derivatives.

Question 3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

The collection of margin for uncleared derivatives is an effective means for any market participant to reduce unsecured counterparty credit risk, thus limiting both counterparty and systemic risk. In our view, margin requirements for uncleared derivatives should not be used as the primary means to incentivize clearing; nor should they penalize market participants for dealing in uncleared derivatives to meet their trading needs for prudent risk management, including entering into customized transactions. This is particularly the case when central clearing is unavailable for certain uncleared derivative products, such as non-clearable TRS⁷ for complex equity trades and other equity derivatives that provide synthetic exposure to physical equities. Given the bespoke terms of such non-clearable equity TRS, it is unlikely that the financial end users who trade them will be able to clear these derivatives for the foreseeable future.

Therefore, the margin rules that will be coming into effect for many MFA members' uncleared trades on September 1, 2019 or 2020 will penalize hedge funds that use non-clearable TRS and other non-clearable derivative products by having to over-collateralize them based on potentially higher IM requirements. One of the underlying policy objectives for the higher uncleared margin requirements is to encourage clearing derivatives that are suitable for clearing. That policy objective has a punitive and disproportionate effect on buy-side market participants who trade non-clearable TRS and collateralize them based on the actual risk posed by such products. MFA has repeatedly expressed this concern to U.S. regulators, and has offered its views on other areas in need of calibration under the new margin rules to avoid adverse effects on many buy-side market participants.⁸

Question 9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

In MFA's view, prudential requirements that inflate the economic risk of derivatives, particularly the leverage ratio, impose artificial barriers for clients to access cleared

⁷ Portfolio swaps or total return swaps are a common type of uncleared swap used by the hedge fund industry.

⁸ See, e.g., MFA Letter to Board of Governors of the Federal Reserve System ("Federal Reserve") on Managed Funds Association Regulatory Priorities, dated Sept. 1, 2017, at pp. 5-6, available at: <https://www.managedfunds.org/wp-content/uploads/2017/09/MFA-Letter-to-Federal-Reserve-on-Regulatory-Priorities.pdf>; MFA Supplemental Comment Letter to the Federal Reserve, dated June 4, 2018, at pp. 4-9, available at: <https://www.managedfunds.org/wp-content/uploads/2018/06/MFA-Follow-up-Fed-Letter-on-Reg-Priorities-Final.pdf>; and MFA Letter to CFTC on Project KISS, dated September 29, 2017, at pp. 26-27, available at: https://www.managedfunds.org/wp-content/uploads/2017/09/MFA-Proj.KISS_final_appendix.9.29.17.pdf.

derivatives and work at cross-purposes with mandates to clear. MFA members note that the leverage ratio is having a direct impact on banks offering clearing services to clients such as investment funds, including cases in which certain banks have exited the clearing business altogether,⁹ or have reduced client clearing services. Our members also have reported that some bank-affiliated dealers are “rationing” their client clearing services by asset size, particularly those banks that are subject to the leverage ratio as a binding minimum capital constraint. For smaller client firms with less active and less profitable trading volume, certain clearing members of CCPs are scaling back or terminating their clearing services to reduce their balance sheets. The cumulative effect of these market exits has been a substantial reduction in clearing capacity in the market. In addition, a reduction in the number of clearing members has concentrated market power in fewer entities, which has reduced competition and increased systemic risk.

Of course, banking organizations allocate capital to business lines based on expected returns. As such, an organization will use its balance sheet to fund businesses that can meet return-on-equity (“ROE”) targets given the amount of capital required to be held against the activities of each business. This explains why many of the larger client firms with active trading strategies that are more profitable for dealers in meeting their ROE targets have not yet been adversely affected by the leverage ratio. However, as this “rationing” trend continues, our members are concerned that there will be fewer competitors and increasing pricing pressure on client clearing services. That pricing pressure will intensify as regulators in different jurisdictions fully implement their respective mandatory clearing initiatives.¹⁰ To ensure that customers have fair and equal access to CCPs, MFA believes it is critical that customer clearing services remain available at an affordable price.

Consistent with the concerns raised in MFA’s September 1, 2017 letter to the Federal Reserve,¹¹ the leverage ratio’s current failure to recognize the purpose of client IM poses a threat to the use of cleared derivatives by customers. Because of the lack of offset for client IM, clearing members will incur large leverage ratio exposures, which will likely result in

⁹ See Deutsche Bank Walks Away From US Swaps Clearing, Financial Times (Feb. 9, 2017), [available at https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655](https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655); State Street Exiting Swaps Clearing Business, Citing New Rules, Bloomberg (Dec. 4, 2014), [available at https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-business-citing-new-rules](https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-business-citing-new-rules); RBS to Wind Down Swaps Clearing Units, Reuters (May 19, 2014), [available at http://uk.reuters.com/article/uk-rbs-primesservices-divestiture-idUKKBN0DY0PU20140519](http://uk.reuters.com/article/uk-rbs-primesservices-divestiture-idUKKBN0DY0PU20140519); BNY Mellon Closes U.S. Derivatives Clearing Business, Pension & Investments (Dec. 20, 2013), [available at http://www.pionline.com/article/20131210/ONLINE/131219993/bny-mellon-closes-us-derivatives-clearing-business](http://www.pionline.com/article/20131210/ONLINE/131219993/bny-mellon-closes-us-derivatives-clearing-business).

¹⁰ 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 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>.

¹¹ See MFA letter to the U.S. Federal Reserve, available at: <https://www.managedfunds.org/wp-content/uploads/2017/09/MFA-Letter-to-Federal-Reserve-on-Regulatory-Priorities.pdf>.

higher fees for customer clearing and needlessly reduce the ability of customers to hedge their economic risks.

MFA members believe that the leverage ratio has a disproportionate adverse impact on certain asset classes of derivatives under the calculation methodology for the CEM. Specifically, portfolios with large notional amounts of commodities and equity derivatives are subject to relatively high conversion factors under the CEM’s standardized matrix approach, as set forth below:

Tenor	Interest Rate	FX and Gold	IG Credit	NIG Credit	Equity	Prec. Metals (Non-gold)	Commodity/Other
<=1 yr	0.0%	1.0%	5.0%	10.0%	6.0%	7.0%	10.0%
<=5 yr	0.5%	5.0%	5.0%	10.0%	8.0%	7.0%	12.0%
>5 yr	1.5%	7.5%	5.0%	10.0%	10.0%	8.0%	15.0%

Source: 12 C.F.R. sec. 217.34, Table 1 (standardized approach) (Federal Reserve rules); 12 C.F.R. sec. 217.132, Table 2 (advanced approaches) (Federal Reserve rules) (footnotes omitted).

MFA encourages regulators to move away from the current CEM-based calculation of credit exposure to a more appropriate calibration of the SA-CCR. SA-CCR offers more risk sensitivity than the CEM by reflecting the exposure of interest rate derivatives through duration adjustments, reflecting netting of exchange-traded derivatives, and allowing for delta adjustments for options contracts.¹²

Compounding the adverse effects of the current formulation of the leverage ratio and the risk insensitivity of the CEM methodology, the Federal Reserve’s proposal to amend the FR-Y-15 reporting instructions for U.S. systemically important banks (“G-SIBs”)¹³ is another prudential requirement that MFA believes would have a material adverse effect on the availability and affordability of client clearing services for derivatives. To the extent that a capital requirement requires a greater amount of capital to be maintained for a G-SIB to engage in a low-return business like derivatives clearing than is warranted by the low risk of such business, G-SIBs will be unable to meet ROE targets without substantially raising prices. As we explained in our comment letter in response to the G-SIB Proposal, given the low-risk nature of derivatives clearing and the inclusion of client performance guarantees within the Size Indicator, increasing the G-SIB Surcharge by also including these guarantees in the Interconnectedness and Complexity Indicators would result in a significant overstatement of risk.¹⁴ This overstatement of risk would disproportionately discourage G-SIBs from providing derivatives clearing services to their clients. Accordingly, we have encouraged the Federal Reserve to withdraw this proposal.

To avoid materially adverse flow-through impacts on the buy-side’s derivatives clearing activity, MFA encourages policy makers to focus their recalibration efforts on three actions: 1) authorize an IM offset in the leverage ratio; 2) transition from the CEM to an

¹² See Basel Committee on Banking Supervision, The Standardised Approach for Measuring Counterparty Credit Risk Exposures (March 2014; rev. April 2014), available at: <https://www.bis.org/publ/bcbs279.htm>.

¹³ 82 Fed. Reg. 40,154 (Aug. 24, 2017), (the “G-SIB Proposal”).

¹⁴ See MFA and SIFMA AMG Letter on Proposed Changes to G-SIB Surcharge Calculation (FR Y-15; OMB Control Number: 7100-0352), dated Oct. 20, 2017, available at: https://www.managedfunds.org/wp-content/uploads/2017/10/SIFMA-AMG_MFA-Comment_on_GSIB_Surcharge_Change_FINAL.pdf.

adjusted SA-CCR method, with offsets for client IM; and 3) withdraw the G-SIB Proposal in the United States.

Question 13. In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

MFA has been a strong supporter of clearing mandates, such as those included in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and believes that clearing (as well as trading mandates) improve pricing and reduce systemic risk. Customers are a vital part of the derivatives markets and have been critical to the success of central clearing. While some clearing of swaps between dealers existed prior to enactment of clearing mandates, artificial barriers to entry prevented customers from similarly participating in the cleared swaps market. Implementation of the central clearing requirement eliminated many of those artificial barriers and resulted in substantial customer clearing.

However, at present, swaps customers exclusively access CCPs indirectly through clearing members, rather than becoming direct members of CCPs, for a variety of reasons, both financial and operational. MFA expects the demand for clearing services to increase as regulators in different jurisdictions fully implement their respective mandatory clearing initiatives. 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.

In conclusion, MFA appreciates the opportunity to provide these comments to the Committees and we encourage the Committees, working together with national regulators, to reconsider aspects of the above rulemakings and to amend the above rules to minimize the distortionary and adverse effects on capital markets described above. We look forward to continuing to work with the policy makers and regulators to develop alternative proposals that seek to achieve the underlying policy objectives in ways that do not unnecessarily affect valuable investment activity that is critical to strong and vibrant capital markets.

If you have any questions regarding any of the information provided above, or if we can provide further information with respect to the issues discussed in this letter, please do not hesitate to contact the undersigned at (202) 730-2600.

Respectfully submitted,

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