sifma
asset management group

September 7, 2018

Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Committee on Payments and Market Infrastructures
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

Re: Response to Consultative DAT Report on Incentives to Centrally Clear OTC Derivatives

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association's Asset Management Group ("**SIFMA AMG**") writes to provide responses to the questions set forth in the consultative document of the Derivatives Assessment Team ("**DAT**") on incentives to centrally clear over-the-counter derivatives (the "**DAT Report**").

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $39 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. They use futures and cleared swaps, as well as other derivatives, for a range of purposes, including as a means to manage or hedge investment risks such as changes in interest rates, exchange rates, and commodity prices.

SIFMA AMG generally supports client clearing of certain derivatives as a means to promote market stability, reduce counterparty risk, and enhance transparency. However, data from our members provided in this letter show that SIFMA AMG member clients have experienced price increases and reduced access to clearing services resulting from the implementation of new capital requirements, most notably the leverage ratio, following the financial crisis. We also have serious concerns that in the event of market-wide stress, capital requirements would significantly disincentivize banks from acquiring a failing clearing members' book of client positions through a "port." These effects have cumulatively increased the costs and reduced the benefits of client clearing from the client perspective. We therefore urge the international standard-setting bodies and domestic regulators to recalibrate the punitive capital regime that currently applies to client clearing activity, including by amending the leverage ratio to recognize the exposure-reducing effect of client initial margin. Such changes to the capital regime would enhance clients' incentives to use cleared derivatives and reduce systemic risk.

Our responses to the DAT's specific questions follow.

Incentives

1. **Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?**

Cleared products have certain advantages for clients, including the reduction of bilateral credit risk, enhanced risk management through a central counterparty, netting of cleared positions, and the ability to "port" a position if their clearing member defaults. A collateral benefit of clearing is that certain cleared products can also become traded electronically, which can help to promote liquidity and improve price transparency. However, clearing also presents some disadvantages, including high fixed costs for accessing clearing services and potentially high fees. Additionally, the relative levels of liquidity between cleared and uncleared products are significant drivers of a client's decision of whether to seek a cleared product. As a result of these factors, clients often view clearing through a cost-benefit lens on a case-by-case basis for each product type, meaning it is may not be economical to clear certain products.

Post-crisis capital requirements that the international standard-setting bodies and domestic regulators have imposed on banks have distorted the cost-benefit equation for clearing. As we discuss below, capital requirements have resulted in clients paying higher fees to access clearing services, increasing the costs of trading cleared products, and have reduced capacity for clearing services. Clients that tend to face more significant fee increases or reduced access to clearing services have smaller, more directional, and longer-term derivatives portfolios, and/or use less active trading strategies. Pension funds, mutual funds, and life insurance companies are among the types of clients in this category. An asset manager may forego entering into a cleared derivative for a smaller client that is quoted high fees.

Capital requirements and a reduction in the number of clearing members have also undermined clients' confidence that porting of a defaulting clearing member's portfolio to one or more other clearing members will function as it should in times of stress, potentially reducing the benefits of trading cleared products.

Given this dynamic, clearing mandates have primarily accounted for the move to central clearing of OTC derivatives traded by SIFMA AMG members' clients since the financial crisis and implementation of G20 reforms. Clients have the greatest incentive to use a cleared product where there is a "critical mass" of liquidity for the product when traded through a central counterparty ("**CCP**"). Robust liquidity pools most often result from clearing mandates. Yet, new clearing mandates would not be an appropriate solution for establishing incentives to seek cleared products. Inappropriate clearing mandates, such as for non-standardized or illiquid product types, could lead to clients foregoing hedging their risks entirely, which would create more risk in the system, increase costs for clients, and have other negative effects discussed in response to question 13, below. Indeed, to date, only the most liquid asset classes – interest rate swaps and certain credit default swaps – have been subjected to the clearing mandates, while others have only been considered, but not subjected to a clearing mandate. The standard-setting bodies and domestic regulators should instead remove barriers to clearing by recalibrating capital requirements to more accurately reflect risk.

2. **Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?**

Please see our responses to question number 1, above.

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?

It is difficult to predict the effects that margin requirements for uncleared swaps will have on SIFMA AMG members' clients before such requirements have fully taken effect for most clients. Nevertheless, we do not believe margin requirements will fundamentally change incentives to clear, as margin requirements are just one part of the overall cost-benefit analysis involved in the decision of whether to enter into a cleared trade.

We also do not believe that the international standard-setting bodies and domestic regulators should design margin requirements with the purpose of disincentivizing trading in uncleared products. Some non-mandated products, such as highly customized hedges, do not lend themselves well to clearing and are not offered by CCPs, even if they are low-risk trades. Additionally, some clients do not have adequate access to clearing services. Imposing minimum margin requirements for these products and clients may simply increase costs rather than generate more clearing activity, and in some cases, could even lead clients to forego hedging certain risks in lieu of entering into cleared or uncleared swaps. The focus of revisions to margin requirements should instead be on reducing counterparty risk, preventing systemic risk, and ensuring that margin requirements do not have pro-cyclical effects by requiring clients to liquidate assets to meet margin calls as volatility increases.

4. The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

The most important regulatory factors affecting incentives for clients to trade cleared derivatives as opposed to uncleared derivatives are clearing mandates and, because they affect clients indirectly, bank capital requirements. The most important non-regulatory factors are liquidity and portability.

Markets

5. Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

Once a sufficient pool of liquidity is established for a specific type of OTC derivative (which can mean, as an example, a specific interest rate swap of a specific duration), the shift to clearing for that product tends to be self-reinforcing through more favorable pricing. Clearing mandates can help drive liquidity in a product toward a critical mass. However, clearing mandates are not appropriate for all products, for the reasons discussed in response to question 13, below. Moreover, the market can sometimes generate sufficient liquidity for a product to be cleared successfully in the absence of a clearing mandate. For example, asset managers sometimes voluntarily use cleared products not subject to a mandate for a client because the remainder of the client's derivatives portfolio is comprised of cleared products subject to a clearing mandate.

6. There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

While portfolio compression is a helpful risk management tool for market participants, it is unlikely to affect access to clearing or pricing for clients that have directional portfolios that cannot be meaningfully compressed.

Asset managers are interested in the direct clearing model, but there are fundamental issues that need to be resolved. First, absent sponsorship by a bank in the form of a guarantee, a small or medium-sized client would be unlikely to satisfy CCP requirements and gain eligibility as a direct member. And any guarantee that a bank provides to sponsor a direct clearing membership would carry a capital charge similar to that currently required for a bank to guarantee a client's default. Therefore, capital requirements would continue to constrain access to clearing for all but the largest clients, and would continue to result in higher clearing fees. Second, direct clearing members would need to be able to contribute to loss mutualization at the CCP, including through *ex ante* default fund contributions and *ex post* loss sharing. These features would make direct clearing membership unattractive for many clients, particularly clients that have fiduciary duties to their investors.

7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

a. central clearing mandates (both in terms of product scope and entity scope);

We agree that clearing mandates have driven the market in mandated products to central clearing, specifically where the clearing mandates are aligned between the U.S. and Europe. Please see our response to question 1, above.

b. minimum standards for margin requirements for uncleared derivatives;

Please see our response to question 3, above.

c. capital requirements for credit valuation adjustment (CVA) risk;

We support any recalibration of the capital rules for CVA risk that creates more risk sensitivity and accuracy with respect to the treatment of client clearing services and thereby removes disincentives for banks to provide clearing services.

d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));

We support any recalibration of the capital rules for jump-to-default risk that creates more risk sensitivity and accuracy with respect to the treatment of client clearing services and thereby removes disincentives for banks to provide clearing services.

e. G-SIB requirements; and

As clearing service providers have exited the market in recent years, clearing has increasingly become concentrated within G-SIBs. The G-SIB surcharge accordingly plays a critical role in determining the capacity for clearing in the market. And the G-SIB surcharge overstates the systemic risk arising from client clearing by, among other things, incorporating the denominator of the leverage ratio into the Size indicator. As discussed immediately below, the leverage ratio denominator treats client clearing punitively and requires banks to maintain a disproportionate amount of capital to support this activity.

f. The leverage ratio.

The leverage ratio substantially overstates a bank's actual economic exposure in a cleared derivative transaction by failing to recognize the exposure-reducing effect of initial margin. This overstatement has disincentivized banks from providing clearing services to SIFMA AMG members and their clients; as a result, SIFMA AMG members and their clients have faced reduced access to clearing services and have paid higher prices for such access.

In June 2016, we conducted a survey of SIFMA AMG members to determine the effect of the leverage ratio's failure to recognize the exposure-reducing effect of segregated initial margin on their ability to access clearing services for clients. Twelve SIFMA AMG members responded to the survey, representing an aggregate of over $1 trillion in assets under management.[1] We believe that if we were to conduct this survey again, the results discussed below would not change significantly and may even show a greater negative impact of the leverage ratio on our members and their clients, given that the leverage ratio became a binding minimum requirement on January 1, 2018.

The survey revealed the following results:

Reduced Access to Clearing Services

Our survey indicated that SIFMA AMG members have had reduced access to cleared derivatives since the introduction of the leverage ratio. For example, a significant number of the survey respondents had been asked to agree to a cap (*i.e.*, a limit on their clients' use of derivatives) on outstanding positions, as reflected in the following table:

Percentage of Respondents That Have Been Asked to Agree to a Cap on Outstanding Positions				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
33%	30%	50%	13%	55%

Some SIFMA AMG members had been forced by their clearing member to terminate clearing relationships (and seek clearing elsewhere, if possible), as reflected in the following table:

Percentage of Respondents That Have Terminated Clearing Relationships Involuntarily				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
8%	10%	30%	25%	18%

Higher Prices

Since the introduction of the leverage ratio, clients have had to pay higher prices to access cleared derivatives, as reflected in the following results from SIFMA AMG's member survey:

[1] *See* SIFMA AMG Letter to BCBS (June 30, 2016), *available at* https://www.sifma.org/wp-content/uploads/2017/05/sifma-amg-submits-comments-to-the-basel-committee-on-banking-supervision-on-revisions-to-the-basel-iii-leverage-ratio-framework.pdf.

Percentage of Respondents That Have Been Asked to Increase Clearing Fees By Product				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
50%	50%	60%	50%	64%

Similarly, SIFMA AMG members have relinquished to their clearing members a greater proportion of income from the reinvestment of posted initial margin:

	Percentage of Respondents That Have Relinquished to Their Clearing Members a Greater Portion of Income from the Reinvestment of Posted Initial Margin				
	Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
Cash	33%	30%	30%	25%	27%
Securities	8%	10%	10%	0%	9%

A substantial number of SIFMA AMG members had been asked by their clearing member to reroute execution business to it, that is, in order to avoid larger increases in clearing fees, to use the same firm for both trade execution and as their clients' clearing account holder. It is common for SIFMA AMG members to use one or more firms for execution, and separate firms for the clearing accounts of the entity the SIFMA AMG member is managing. Clients pay separate fees for clearing and for execution of derivatives. Investment advisers acting as fiduciaries have an obligation to obtain "best execution" for clients' transactions, meaning that the terms for each client transaction generally must be the most favorable terms reasonably available under the circumstances.[2] As a result, SIFMA AMG members often must accept higher *clearing* fees for their clients to obtain lower *execution* fees:

Percentage of Respondents That Have Been Asked to Reroute Execution Business to Avoid Larger Increases in Clearing Fees				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
58%	50%	40%	25%	27%

SIFMA AMG members have experienced higher fees particularly where they post initial margin in the form of cash:

	Percentage of Respondents That Have Been Charged Increased Fees for Posting Initial Margin				
	Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
Cash	42%	40%	40%	13%	27%
Securities	17%	10%	20%	0%	9%

We believe these results establish that the leverage ratio has been the ***direct cause*** of the increase in client fees. Despite the fact that cash is the safest and most liquid form of margin, our members' experience has been that some clearing members prefer not to have clients post margin in the form of cash. Clearing members often prefer initial margin to be in the form of securities because under operative accounting standards, cash initial margin posted to a clearing member is generally reflected on the clearing member's balance sheet, which, as the DAT Report recognizes, adds to the clearing member's total leverage exposure under the leverage ratio.

The standard-setting bodies and domestic regulators should address these issues by amending the leverage ratio denominator to recognize the exposure-reducing effect of initial margin. Such an amendment would eliminate a key disincentive for banks to provide clearing services to clients, which should lead to

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2 Securities Brokerage and Research Services, Release No. 34-23170 (Apr. 23, 1986); In the Matter of Kidder, Peabody & Co., Inc., et al., Investment Advisers Act Release No. 232 (Oct. 16, 1985); Securities Exchange Act Release No. 12251 (Mar. 24, 1976); Securities Exchange Act Release No. 9598 (May 9, 1972).

lower prices and greater access to clearing, and therefore support incentives for clients to seek cleared products.

8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

Please see our responses to question number 7, above.

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?

As discussed in response to question number 7, above, policymakers should recalibrate capital requirements to enhance incentives to provide client clearing services, and thereby enhance incentives for or access to central clearing of OTC derivatives.

Policymakers should also consider other measures that would remove barriers to porting of clients' positions in the event of a clearing member default. For instance, the capital rules could provide relief for newly onboarded clients. Such relief would reduce a key disincentive for other clearing members to acquire the portfolio of the defaulted clearing member. In times of system-wide stress, other clearing members are likely to be constrained by capital requirements, and therefore may be unwilling to step in to acquire the portfolio absent capital relief. Similarly, policymakers should consider adopting temporary relief from prescriptive KYC/AML requirements so that other clearing members can rapidly onboard the clients of a failing clearing member without any significant lapse in time.

Finally, policymakers should continually reevaluate and strengthen policies that affect CCP resilience and customer protection to ensure appropriate safeguarding of client assets. Clients have greater incentives to seek cleared products when they have confidence that their funds at a CCP will not be subject to loss based on the default of one or more other market participants.

Access

10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:

a. accessing clearing arrangements; and

We agree that clients, especially those with smaller or more directional derivatives activity, are facing difficulties accessing clearing arrangements. See our response to question 7.f., above, for data supporting this conclusion.

b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

We agree that clients, especially those with smaller or more directional derivatives activity, are facing difficulties conducting trading and/or hedging activity. See our response to question 7.f., above, for data supporting this conclusion.

11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

We agree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks. Since the Basel Committee introduced the leverage ratio in 2010, and particularly since banks began reporting their leverage ratios to their national supervisors in 2013, a series of large banks have shut down their client clearing businesses in some or all markets around the globe,[3] and banks have not newly entered the clearing business. We believe the cumulative effect of these market exits has been a substantial reduction in clearing capacity in the market.

It is important to view these market exits in context. Global clearing mandates implementing the Pittsburgh G20 Commitments have required certain swaps that previously were bilateral transactions to be centrally cleared. These mandates have created significant demand for clearing services and have resulted in a dramatic rise in overall clearing volumes in recent years. A decrease in the number of firms willing to supply these services due to the increased capital costs over the same period underscores just how difficult the leverage ratio has made it for banking organizations to continue to clear derivatives for clients.

Given current levels of concentration, SIFMA AMG has serious concerns about the systemic risk potentially posed by the concentration of clearing members, as well as the portability of a failing clearing member's book of cleared derivatives to other clearing members in times of system-wide stress. In a time of system-wide stress, when capital buffers decline, the leverage ratio is more likely to serve as a binding capital constraint on banks throughout the market. In these circumstances, a bank might be required to raise capital in order to acquire a book of cleared derivatives from a failing clearing member, which would make the bank much less willing to step in to acquire the book. The leverage ratio would therefore be pro-cyclical, intensifying market stress at exactly the wrong moment. This pro-cyclical effect is likely to be more pronounced given the small numbers of clearing members currently in the market.

Concentration creates issues in addition to portability. For instance, UCITS are subject to regulatory counterparty concentration limits. Mandatory clearing, in combination with increasing concentration of clearing service providers, creates challenges for these funds.

12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:

a. using clearing services?

We agree that high upfront and ongoing costs associated with IT, staffing and other operational costs, liquidity requirements, and minimum fees, are required to use clearing services. An asset manager and/or its client bears the initial cost of establishing access to clearing services each time it opens a new account or fund. Additionally, an asset manager and/or client must bear substantial upfront costs if its

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[3] *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; Nomura Exits Swaps Clearing for US and European Customers, Financial Times (May 12, 2015), *available at* https://www.ft.com/content/e1883676-f896-11e4-be00-00144feab7de; 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; RBS to Wind Down Swaps Clearing Units, Reuters (May 19, 2014), *available at* http://uk.reuters.com/article/uk-rbs-primeservices-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.

clearing member exits the market, as has happened a number of times in recent years due to onerous capital requirements – sometimes abruptly. Each transition to a new clearing member takes a substantial amount of time to complete and can leave a client without a primary or backup clearing member in the interim. As described in response to question 1, above, these costs and timing considerations can affect a client's willingness to use cleared products, particularly for non-mandated derivatives where there is liquidity in uncleared markets.

b. providing client clearing services?

Our understanding is that capital requirements have substantially increased the costs of providing client clearing services. Banks have passed on a substantial amount of these increased costs to their clients.

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.

In our view, the set of OTC derivatives that can be cleared safely and efficiently (*i.e.*, certain standard interest rate swaps and credit default swaps) is generally already subject to clearing mandates. Derivatives should only be subject to clearing mandates, or otherwise be incentivized by regulation, when they are suitable for clearing. Mandatory clearing should not be extended to products that could put CCPs at risk of substantial losses or insolvency. Additionally, forcing unsuitable products into clearing could lead to standardization of those products into swaps that are imperfect hedges for clients' risk mitigation purposes. It also could lead to margin requirements that make hedging uneconomical. Clients might react to these conditions by choosing not to hedge their risks.

14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

For the smallest clients, the fixed and variable costs of clearing can make entering into cleared trades uneconomical, particularly where there are separate liquidity pools in cleared and uncleared markets. Additionally, capital constraints can make banks unwilling to clear for the smallest clients that do not generate substantial volume-based fees. However, once liquidity reaches a critical mass in cleared markets, smaller clients are more likely to have incentives to clear, regardless of whether a clearing mandate or margin requirements for uncleared swaps apply to the type of derivative and client. As a result, we believe that a recalibration of capital requirements associated with client clearing that increases liquidity and capacity in the market would significantly benefit the smallest and least active clients and would remove disincentives to clear for clients of all sizes.

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We appreciate the DAT's consideration of our responses, and hope our members' experiences will inform the results of the international standard-setting bodies' reviews of the capital regime for client cleared derivatives, including the leverage ratio. Asset managers' clients have now experienced the serious negative effects of this regime for years. We urge the DAT to recommend changes to the capital regime discussed above to remove disincentives for banks to clear derivatives for their clients.

Should you have any questions, please do not hesitate to contact us at Tim Cameron at (202) 962-7447 or tcameron@sifma.org or Jason Silverstein at (212) 313-1176 or jsilverstein@sifma.org, or our counsel at Covington & Burling LLP, Stephen Humenik at (202) 662-5803 or shumenik@cov.com or Randy Benjenk at (202) 662-5041 or rbenjenk@cov.com.

Respectfully submitted,

/s/ Timothy W. Cameron
Timothy W. Cameron, Esq.
Managing Director
Asset Management Group – Head
Securities Industry and Financial Markets Association

/s/ Jason Silverstein
Jason Silverstein, Esq.
Asset Management Group – Managing Director
and Associate General Counsel
Securities Industry and Financial Markets
Association