SPEECHES & TESTIMONY

Opening Statement of Commissioner Brian Quintenz before the CFTC Energy and Environmental Markets Advisory Committee

"Gold Plating to Nowhere"

April 17, 2019

Thank you Commissioner Berkovitz for convening today's meeting of the Energy and Environmental Markets Advisory Committee (EEMAC). I am delighted to join you and my fellow Commissioners for the Committee's first meeting in over three years and its inaugural meeting since it was reconstituted last year. Before we begin, I would like to welcome the Committee's new members and thank them for so generously giving us their time and expertise.

This Committee plays an invaluable role in advising the Commission about areas essential to our core mission, including ensuring that producers, merchants, and users of energy and environmental products are able to reliably access the derivatives markets to manage and hedge their commercial risks. There is a packed agenda before us today and I look forward to hearing all three panels' discussion of the developments and challenges associated with physical commodity derivatives trading.

I am looking forward to hearing from the CFTC's own Chris Goodenow of DMO's Market Intelligence Branch to discuss two very impressive research reports regarding liquefied natural gas (LNG) developments and the impact of U.S. tight oil on NYMEX WTI futures. Over the past ten years, the United States has gone from being a net importer to a net exporter of LNG. Natural gas production has increased dramatically, accompanied by a similar growth in financial trading. I do not believe this transformative growth in domestic natural gas production could have occurred without the robust derivatives markets we have in the United States, which enable exploration and production companies to effectively manage their commercial risks. Both these reports demonstrate how liquid futures markets with prices reflective of market fundamentals, including supply and demand forces, support real economic growth. They also reflect CFTC staff's ongoing commitment to better understand the relationship between futures markets and the underlying cash markets.

Today's final panel will focus on an issue critical to well-functioning derivatives markets: the availability of clearing services for commercial end-user clients. As I have noted previously, I have serious concerns that the current implementation of the supplementary leverage ratio (SLR) is limiting clients' access to clearing and further encouraging FCM consolidation.

Most recently, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation proposed a new approach for calculating the exposure amount of derivatives contracts under the agencies' regulatory capital rule. [1] The Proposal would move away from the current exposure methodology (CEM), replacing it with the standardized approach for counterparty credit risk (SA-CCR) methodology for purposes of calculating risk-weighted assets under the capital rule. The Proposal also incorporates a modified version of SA-CCR into a firm's SLR calculation. The implementation of SA-CCR for both risk-weighted assets and SLR calculations will have a profound impact on the derivatives markets, particularly with respect to commercial end-users.

With respect to the SLR calculation, the Proposal continues to require a clearing member FCM to include in its leverage calculation the full exposure resulting from its guarantee of a client's trade, without reducing this exposure by the amount of segregated margin posted by the client, and then counts this margin as a source of leverage against which additional capital should be held. This thinking ignores the fact that segregated margin will always be used to absorb client losses before the central counterparty looks to the clearing member to absorb any residual losses.

Moreover, the clearing member cannot use the margin to leverage itself under any circumstance.[2] As a result, segregated margin is not just risk-free. It is actually more than risk-free—it is always risk-reducing. This policy is like requiring a bank to hold capital against both a mortgage loan *and the house*. If the goal of the leverage ratio is to calculate the clearing member's most accurate amount of leverage, then it should never count segregated client margin.

I joined a comment letter along with some of my fellow Commissioners highlighting our significant concerns that unless the treatment of client margin changes, clearing member firms will continue to limit the provision of clearing services to clients. In a recent study, 72% of client clearing service providers stated that the current leverage ratio disincentivizes providing client clearing services.[3] Moreover, 70% of clients who were able to maintain their clearing services agreements stated restrictions had been placed on their cleared derivatives activity.[4] Including an initial margin offset in a firm's SLR calculation would have a meaningful impact on a firm's ability to continue to offer client clearing services. One comment letter to the Proposal estimated that including an offset for initial margin would decrease banking organizations' client clearing exposures by 37%.[5]

Let me say that I appreciate the fact that a question was included in the release about this topic, which I believe shows the Prudential Regulators' willingness to listen to fellow regulators, market participants, and data analysis. Unfortunately, this question only represents one small step forward for process, whereas, in other areas, the Proposal contains giant leaps backward for policy.

With respect to calculating counterparty credit risk and risk-weighted assets for commodity derivatives, the Proposal would potentially increase transaction costs and diminish market liquidity for commercial end-users. This potential outcome arises in part because the Proposal takes the Basel Committee's already arbitrary and inflated supervisory factors for the various commodity asset classes and "gold plates" them, proposing the highest supervisory factor across all energy commodities. The Basel Committee did at least distinguish between electricity and oil/gas commodities, assigning the latter a much lower supervisory factor compared to the 40% charge for electricity contracts. While I have significant concerns with the quality of the data analysis, or perhaps total lack thereof, which led to this arbitrary Basel Committee decision as it is, I am shocked that, with just as little explanation, the Proposal uniformly applies electricity's grossly inflated supervisory factor of 40% *to the entire energy hedging set*. The result is an enormously punitive treatment of oil and gas derivatives transactions that, according to some commenters, would increase a bank's exposure calculations under SA-CCR with an end-user counterparty by up to 460%.[6] Increased exposure calculations will result in higher capital charges to the bank, which, in turn, the bank will likely pass along to the end-user in the form of higher transaction pricing.

Gold plating a bad idea does not magically transform it into a good idea. By way of analogy, if you build a ship out of gold, it looks great in dry dock. But when you put that ship in the water, it becomes the world's most expensive scuba diving attraction.

I believe the Proposal should revisit the supervisory factors for all types of commodities to ensure they are appropriately calibrated to the actual risks of the underlying commodity and the maturity of the derivatives contract.

Similarly, in order to ensure that end-users' exposures to bank counterparties are not over-inflated, I hope the Prudential Regulators consider recognition of non-cash collateral arrangements under SA-CCR, like asset liens. Alternative collateral arrangements are frequently used in derivatives transactions with end-users and are effective means of reducing the bank's exposure. The recognition of these risk-reducing arrangements would increase the risk-sensitivity of SA-CCR and reduce the possible increased transaction costs passed on to commercial end-users by bank counterparties.

I look forward to hearing from the panelists today about how the Proposal could impact their ability to effectively hedge the risks of their core businesses, either through reduced access to clearing, higher transaction costs, or a diminished willingness of bank counterparties to engage in uncleared swap transactions.

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[1] Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, 83 Fed. Reg. 64,660 (proposed Dec. 17, 2018) (hereinafter, the "Proposal"), *available at* https://www.federalregister.gov/documents /2018/12/17/2018-24924/ standardized-approach-for-calculating-the-exposure-amount-of-derivative-contracts.

[2] 17 C.F.R. §§ 1.20-1.30 (futures); 17 C.F.R. §§ 22.2-22.7 (cleared swaps). These rules require FCMs to separately account for, and segregate as belonging to the client, all money, securities, and property received from a client as margin. The FCM cannot re-hypothecate the margin to leverage the bank and must maintain the collateral in cash or certain other very low risk, highly liquid assets, such as U.S. government and municipal securities "with the objectives of preserving principal and maintaining liquidity." 17 C.F.R. §1.25.

[3] Incentives to Centrally Clear Over-the-Counter Derivatives: A Post-Implementation Evaluation of the G20 Financial Regulatory Reforms, Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures, the Financial Stability Board and the International Organization of Securities Commissions 24 (August 7, 2018), http://www.fsb.org/wp-content/uploads/P070818.pdf.

[4] *Id.*

[5] Joint Comment Letter from International Swaps and Derivatives Association, Inc. ("ISDA"), the Securities Industry and Financial Markets Association ("SIFMA"), the American Bankers Association ("ABA"), the Bank Policy Institute ("BPI"), and the Futures Industry Association ("FIA") at 12 (March 18, 2019), https://www.isda.org/2019/03/18/industry-response-to-standardized-approach-for-counterparty-credit-risk-sa-ccr.

[6] Comment Letter from Coalition for Derivatives End-Users at 5 (March 18, 2019).