

SPEECHES & TESTIMONY

Remarks of Commissioner Brian Quintenz before the Structured Finance Industry Group Vegas Conference

February 26, 2018

Introduction

Good morning. Thank you for that very kind introduction.

Before I begin, let me quickly say that the views contained in this speech are my own and do not represent the views of the Commission. I'm very pleased to be speaking here with you today at the Structured Finance Industry Group Vegas Conference.

Las Vegas is an exciting place. I know the first thing everyone wants right now is to have a Washington, D.C. regulator stand up and read a detailed policy speech line by line. So I'm going to do something different this morning. I'm going to tell you a joke. And then I'm going to read a detailed policy speech line by line.

I'm a fisherman, so I wanted to start off with a story about two old guys on a fishing trip. They are out in the middle of nowhere, on an island in Canada let's say. Their trip has come to an end. A pontoon plane lands at their remote location to pick them up. After they load up and get on board, the weather deteriorates badly. The pilot tells them that they can't take off and will have to wait for the weather to clear. One of the old guys looks up, and with bloodshot, glassy eyes, he tells the pilot, "Weather was worse than this last year and that pilot took off!" Not wanting his reputation with potential customers to suffer, the pilot reluctantly agreed to hit the throttle. The plane lifts off from the lake but alas, clips a tree on the other shoreline and crashes into the woods. The old men are thrown from the plane. One of them gradually comes to, sees his friend and asks out loud, "Joe, where are we?" The other old man raises his head, looks around, and says, "Ehh? Hmmm. Looks like about a hundred yards further than last year."

The point of the joke is that incentives can make people do things they otherwise wouldn't chose or want to do.

In the aftermath of the financial crisis, Congress called for, and federal regulators implemented, a vast array of reforms to strengthen the global

financial system. However, questions remain as to whether some of those reforms accurately target the specific risks intended, if the reforms are calibrated appropriately vis-à-vis each other, and what incentives or disincentives they create. Indeed, there can be a fine line between reforms that strengthen the financial system versus those that punish it.

My concern is that, ten years post crisis, many regulators (the CFTC included) failed to appropriately assess the risks that they sought to control and that, as a result, we may be dis-incentivizing activity necessary to a healthy market and economy. For example, I continue to hear repeatedly, in the press and in public statements, about how derivatives are inherently “risky” – even standardized, cleared derivatives. I do not share this one-size-fits-all view. Quite the opposite, I think futures and swaps are powerful tools to manage and efficiently transfer risk to those most able to bear it and best able to price it. Yet many, especially those unfamiliar with the swaps market and the clearing model, still view every derivative as a bilateral, uncollateralized, undisclosed “risky bet” even when the derivative is an economic hedge that is cleared, margined, and publicly reported.

Whether this view originates from a global framework or is home grown, I think regulators everywhere always need to revisit any one-size-fits-all approach to derivatives risk. Because history has certainly shown us that when Washington prices financial risk, it usually gets it wrong.¹

Today I would like to focus on three areas where, in my view, the risk of derivatives has been or is still being mispriced: measuring derivatives exposure, recognizing risk-reducing offsets, and calculating margin for uncleared swaps.

Swap Dealer Capital

Swap dealer registration subjects entities to significant costs and regulatory burdens. For some firms, capital costs may be the most determinative factor in their decision to remain, or become, swap dealers. If capital costs are too expensive, firms will leave the market or reduce their activity under the registration requirement. As a result, the swaps markets over time will become less liquid, more heavily concentrated, and less competitive. Those are not the hallmarks of a healthy financial system. To promote a vibrant swaps market, I believe it is critically important that the CFTC finalize a capital rule that is appropriately calibrated to the true risks posed by an entity’s swap dealing business.

I commend the general approach taken by CFTC staff in their December 2016 capital proposal (Proposal).² The Proposal presents alternative

capital approaches and permits firms to choose the approach that best matches their corporate and operating structures.³ Where possible, staff deferred to existing capital regimes of other domestic regulators in order to minimize conflicting or duplicative requirements. This is an appropriate approach where other regulators' regimes are updated and reflect a calibrated approach to modern derivative instruments.

For example, under the Proposal's Bank-Based Approach, some firms would be required to use standardized formulas based on a method developed over thirty years ago. That method, the current exposure method (CEM), has been widely criticized as overstating a firm's derivative exposure due to overly simplistic calculations that do not reflect actual risk.⁴ In 2014, Basel signed off on an alternative approach, the Standardized Approach to Counterparty Credit Risk (SA-CCR), as a more risk-sensitive replacement for CEM.⁵ However, it has not yet been implemented in the United States, and the transition may have a long runway. Consequently, CEM remains the basis of the standardized approach codified in U.S. regulations.

This places the CFTC in a difficult position. We could incorporate CEM, a flawed approach to calculating derivatives exposure, into our own regulations for the sake of consistent regulations and simplified compliance. Or, we could develop a new methodology that more accurately reflects exposure (SA-CCR or otherwise), but which creates compliance complexity and regulatory inconsistency.

Neither outcome is entirely positive, however I see this as an opportunity for the Commission to be a thought leader and to make the case for a new alternative, one that takes into account the practical realities of the complex regulatory landscape, but also advocates for a more risk-sensitive approach reflective of this Commission's expertise and experience in the derivative space.

I look forward to discussing these and other issues with staff and market participants as the Commission moves forward with finalizing the capital rule. The Commission has an opportunity to further refine its proposed capital calculations to better reflect the true risk of the swap dealer's exposure and ensure that a firm's capital requirement is proportionate to its risks.

Of course, our agency's own proposed capital regulation is but one example of where the regulatory treatment of derivatives could be revised to more accurately address risk.

Supplementary Leverage Ratio

Another example is the Supplementary Leverage Ratio (SLR). The Basel Committee on Banking Supervision adopted the SLR as a non-risk based “backstop” to prevent the build-up of excessive leverage in the banking sector and to complement its risk-based capital framework.⁶ Under this approach, banks must hold a certain minimum amount of capital against their aggregate on- and off-balance sheet exposures, regardless of the actual risk profile of their assets.

As a true backstop, a leverage ratio can make some sense. However, as a binding capital constraint, especially on conditional or probabilistic off-balance sheet exposures, a leverage ratio creates many perverse outcomes and is a poor regulatory construct. When a risk-neutral capital regime becomes a binding constraint, banks are encouraged to divest themselves of lower risk assets with lower returns in favor of riskier assets with higher rates of return. This is exactly what we are currently seeing with the SLR’s outsized negative impact on clearing and custody services that are the heart of the futures and swaps markets.

More significantly, the SLR penalizes banks’ provision of clearing services by treating segregated customer margin as an exposure of the bank. Let me repeat that, the SLR characterizes segregated customer collateral that it holds in case of a customer’s default as an exposure of the bank and requires the bank to hold capital against it.

This may be a good time to take a step back and discuss the role of futures commission merchants (FCMs) and, more generally, the agency clearing model in the United States. Under the agency model, a clearing member FCM acts as an agent for its client, allowing the client to enter into the derivatives transaction with the central counterparty (CCP). Typically the clearing member FCM guarantees the client’s performance to the CCP, but not the CCP’s performance to the client.⁷ During the life of the trade, the client regularly posts margin to absorb any losses generated by the trade and help guarantee the client’s future performance. This margin is segregated from the FCM’s own funds and held by the CCP or a third party custodian bank.

It is important to understand the true exposure of the clearing member FCM under this agency transaction, which only arises from the possibility that the client goes bankrupt or is otherwise unable to satisfy the losses under the transaction with the CCP. In that situation, the client’s segregated margin would be applied to any amounts owed to the CCP with the clearing member FCM covering the remainder. In effect, the clearing

member FCM's true economic exposure for the cleared trade is limited to any amounts owed to the CCP that exceed the value of the client's margin.

Under the SLR, the clearing member FCM must include in its leverage calculation its exposure resulting from its guarantee of the client's trade. I believe this is an appropriate requirement. However, the SLR calculation prohibits clearing member FCMs from reducing this exposure by the amount of segregated margin posted by the client and then counts it as a source of leverage against which additional capital should be held.

This ignores the fact that segregated margin will always be used to absorb client losses before the CCP looks to the clearing member to absorb any residual losses. When margin is segregated, it remains an asset of the customer. It is only at the disposal of the clearing member FCM under a client default scenario and then can only be used to reduce the resulting exposure to the clearinghouse.⁸ The clearing member cannot use the margin to leverage itself under any circumstance. As a result, segregated margin is not just risk-free. It is actually more than risk-free—it is always *risk-reducing*. If the goal of the SLR is to calculate the clearing member's most accurate exposure for a cleared trade, the SLR should always use the amount of segregated client margin as an offset.

The impact of this is no small matter. By one estimate, the average leverage exposure of the 14 largest clearing members was 80 percent higher when they were prohibited from using margin as an offset as compared to when offset was permitted.⁹

Without relief, I fear we will see additional FCMs exit the clearing business and the worrisome trend of FCM consolidation will continue. In recent years, five major banks have shuttered their swaps clearing businesses.¹⁰ As of 2017, the top five swaps clearing members controlled up to 75% of the business.¹¹

In the months ahead, I look forward to continuing conversations with domestic and international regulators about the risk-reducing nature of segregated margin. I hope through this ongoing dialogue we can work together to revise the SLR calculation to accurately reflect margin's purpose and ensure that client clearing services are encouraged, rather than penalized.

Ten-Day Liquidation Period for Uncleared Swaps

The Dodd-Frank Act instructed the Commission, prudential regulators, and the SEC to adopt margin requirements for uncleared swaps to “offset the greater risk” they pose to the swap dealer and the financial system.¹² The

Act also directed regulators to ensure these margin requirements were “appropriate for the risk associated with the non-cleared swaps held as a swap dealer.”¹³ Unfortunately, in my opinion, the margin requirements adopted by the Commission and U.S. prudential regulators in late 2015 for uncleared swaps contain many of the flaws discussed above.¹⁴ They incorporate standardized approaches to calculating margin that result in punitive margin requirements for uncleared swaps and fail to adequately differentiate among the risk profiles of different uncleared products.

Under the Commission’s final rules, initial margin for uncleared swaps must be calculated using either a standardized, grid-based method or models. Many swap dealers currently use the Standard Initial Margin Model (SIMM) developed by ISDA to calculate their initial margin charges because it is more cost-effective than the standardized approach.

When using models, firms must use a ten-day liquidation period for all swaps, regardless of the swap’s underlying liquidity or risk profile.¹⁵ In contrast, the minimum liquidation time for cleared agricultural, energy and metals swaps is one-day for purposes of calculating initial margin and five days for cleared interest rate and credit default swaps.¹⁶ Although the ten-day liquidation period is consistent with international standards and rules adopted by U.S. prudential regulators, there does not appear to be any empirical evidence to justify the selection of a ten-day window.¹⁷ Therefore, it is unclear why the rules assume, for example, that an uncleared commodity swap should have a liquidation period ten times longer than a cleared commodity swap.

Indeed, many commenters raised this point with the Commission and recommended liquidation periods that were tailored to the particular liquidity risks of the swap, rather than imposing a one-size-fits-all liquidation period.¹⁸ One proposed alternative suggested allowing models to use market-based liquidation periods, subject to CFTC oversight.¹⁹ However, the rule was finalized with the across-the-board, ten-day liquidation period unchanged.

As a result, under our final margin requirements, uncleared swaps tend to be more costly relative to cleared swaps. Yet, many companies have complex hedging needs that cannot be adequately managed by standardized cleared products. Highly-customized, uncleared swaps are an irreplaceable form of precise hedging for American businesses. These companies are now being forced to choose between more precise hedging instruments that are more expensive versus less expensive hedging

strategies with cleared products that are suboptimal and don't align with their economic needs.

In one example from Congressional testimony, a pension fund's costs of hedging had risen 2000% since derivative reforms were put into place.²⁰ Imagine that for a second. The additional costs are roughly equivalent to hiring 20 people to sit behind the employee who is responsible for hedging transactions, but contribute nothing. Speaking of pension funds, their managers often use total return equity swaps to change their plans' market exposure over short to medium time frames. But, these swaps' customized notional values and life spans (tenor) means they are not cleared and therefore subject to a 10-day liquidation horizon for margin calculations. Could someone, anyone, please give me a credible example of an S&P 500 total return swap that would take longer than one or two days to liquidate?

Ironically, this rule's promotion of cleared derivatives may result in increased systemic risk if businesses execute mismatched hedges with increased basis risk or forgo hedging altogether because of cost. And of course, the economic costs of initial margin are not just the funds set aside to meet margin requirements. They also include the firm's opportunity cost of lower returns from investing funds in eligible collateral rather than preferred investment opportunities.

In the final rule, the Commission itself acknowledged that not all uncleared swaps would require a 10-day liquidation period and that the requirement could lead to excessive initial margin.²¹ We now have the benefit of one and a half years of implementation experience.²² The Commission could now re-evaluate the impact of the 10-day liquidation window with the benefit of actual data. In addition, it could reconsider the feasibility of adopting a tailored approach by asset class or common product types.

Conclusion

I recognize that the CFTC's regulations are part of a broader regulatory framework. Unilateral rule amendments by the CFTC that are not broadly accepted by other regulators may create as much confusion as relief. But we are still a regulator and have an obligation to make good public policy decisions based on sound logic and economic reality. As the regulator closest to, and with the most experience in, the derivatives markets, we will keep a keen eye on whether the costs imposed on derivatives by the total domestic regulatory framework are calibrated to actual risk or creating perverse outcomes. When we identify areas where regulations misprice risk and punish derivatives markets, we will confer with our regulatory

counterparts and assist them in better understanding the reality of those impacts.

I started off with a joke about the two fishermen. As a fisherman myself, when the pilot told them he couldn't take off, they should have gotten out of the plane with joy that they had another chance to do more fishing.

Similarly, with the election of President Trump and the team of high quality regulators he has put in place, we now have a second chance to get these financial capital rules and economic incentives aligned. I'm optimistic that we can take full advantage of that opportunity and I look forward to having the CFTC lead the way.

Thank you very much for your kind invitation. I appreciated being here with you this morning.

1 See Melody Peterson, *S.E.C. Warns Banks Against Overgenerous Reserve Levels*, N.Y. Times (Nov. 14, 1998), <http://www.nytimes.com/1998/11/14/business/sec-warns-banks-against-overgenerous-reserve-levels.html>; and Peter Wallison, *Bad History, Worse Policy: How a False Narrative about the Financial Crisis Led to the Dodd-Frank Act 131* (Rowman & Littlefield 2013).

2 Capital Requirements of Swap Dealers and Major Swap Participants, 81 Fed. Reg. 91252 (Dec. 16, 2016), <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2016-29368a.pdf>.

3 Swap dealers that are also registered futures commission merchants must compute their capital requirements under CFTC Regulation 1.17.

4 Basel itself has recognized the limitations of CEM and proposed a more risk-sensitive approach to calculating counterparty credit risk. In doing so, Basel acknowledged that, "CEM had been criticized for several limitations, in particular that it did not differentiate between margined and unmargined transactions, that the supervisory add-on factor did not sufficiently capture the level of volatilities as observed over recent stress periods, and the recognition of netting benefits was too simplistic and not reflective of economically meaningful relationships between derivatives positions." Basel Committee on Banking Supervision, *The standardized approach for measuring counterparty credit risk exposures 1* (March 2014), <https://www.bis.org/publ/bcbs279.pdf>.

5 *Id.*

6 Basel Committee on Banking Supervision, Basel III leverage ratio framework and disclosure requirements 1 (Jan. 2014), <http://www.bis.org/publ/bcbs270.pdf>.

7 For a description of the agency clearing model, please see letter from FIA and ISDA to the Board of Governors of the Federal Reserve System (Nov. 22, 2017) regarding Supplemental Information Regarding Proposed Agency Information Collection Activities, https://www.federalreserve.gov/SECRS/2018/January/20180130/ICP-201723/ICP-201723_122117_131913_489732946702_1.pdf.

8 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.

9 This calculation used the Standardized Approach for Counterparty Credit Risk (SA-CCR) method to calculate a firm’s exposures. See FIA Letter to Basel Committee on Banking Supervision, Response to Basel Leverage Ratio Consultation Regarding the Proposed Calculation of Centrally Cleared Derivatives Exposures Without Offset for Initial Margin and its Impact on the Client-Clearing Business Model (July 6, 2016), https://fia.org/sites/default/files/2016-07-06_FIA_Comment_Letter_Basel_Committee_Leverage_Ratio.pdf.

10 The five firms are Deutsche Bank (<https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655>), Nomura (<https://www.ft.com/content/e1883676-f896-11e4-be00-00144feab7de>), RBS (<http://uk.reuters.com/article/uk-rbs-primerservices-divestiture-idUKKBN0DY0PU20140519>), State Street (<https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-business-citing-new-rules>) and BNY Mellon (<http://www.pionline.com/article/20131210/ONLINE/131219993/bny-mellon-closes-us-derivatives-clearing-business>).

11 Percentage calculated using total customer funds held for swaps as a proxy for total clearing activity. See FIA FCM Tracker, FCM Comparison Table, available at <https://fia.org/fcm-comparison-table>.

12 CEA Section 4s(e)(3)(A).

13 CEA Section 4s(e)(3)(A)(ii).

14 Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 74840 (Nov. 30, 2015); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule, 81 Fed. Reg. 636 (Jan. 6, 2016), <http://www.cftc.gov/idc/groups/public/@lfederalregister/documents/file/2015-32320a.pdf>.

15 17 C.F.R. §23.154(b)(2)(i).

16 17 C.F.R. §39.13(g)(2).

17 Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions, Margin requirements for non-centrally cleared derivatives 11 (Sept. 2013), <https://www.bis.org/publ/bcbs261.pdf>.

18 NERA Economic Consulting, Cost Benefit Analysis of the CFTC's Proposed Margin Requirements for Uncleared Swaps (Dec. 2, 2014); letter from Pension Coalition dated Nov. 24, 2014 (supporting a 3-5 day close-out period); letter from Committee on Capital Markets Regulation dated Nov. 24, 2014 (recommending the Commission consider the liquidity characteristics of different types of non-cleared swaps); letter from SIFMA Asset Management Group dated Nov. 24, 2014 (liquidation period should be closer to five days than ten days).

19 NERA Economic Consulting, Cost Benefit Analysis of the CFTC's Proposed Margin Requirements for Uncleared Swaps (Dec. 2, 2014).

20 *Reauthorizing the CFTC: End-User Views Before the Subcomm. On Commodity Exchanges, Energy, and Credit of the H. Comm. on Agriculture*, 114th Cong. 5 (2015) (statement of Lisa Cavallari, Director of Fixed Income Derivatives, Russell Investments on behalf of the American Benefits Council).

21 Additionally, the Commission noted, "the Commission expects that most of the instruments that could be liquidated in less than 10 days are currently being cleared, and therefore, the impact of the requisite 10 day close-out period may be limited." 81 Fed. Reg. at 685.

22 Initial margin requirements for certain covered swap entities went into effect September 1, 2016. See 81 Fed. Reg. at 675.

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