Public Statements & Remarks

Supporting Statement of Commissioner Brian Quintenz Regarding Establishing Capital Requirements for Swap Dealers and Major Swap Participants and Amending Existing FCM Capital Requirements

July 22, 2020

Ten years and one day ago, the Dodd-Frank Act Wall Street Reform and Consumer Protection Act was enacted. I am proud to vote for today's final rule which, in my view, is the capstone of the Commodity Futures Trading Commission's (CFTC or Commission) work to appropriately calibrate the post-crisis reforms. Capital ensures that firms are able to continue to operate during times of economic and financial stress by providing an adequate cushion to protect them from losses. Just as important as the safety and soundness of individual firms, capital is designed to give the marketplace confidence that any given firm has a high probability of surviving the next crisis.

But, capital requirements also create important incentives that drive market behavior. The cost of capital may be the most determinative factor in a firm's decision to remain, or become, a swap dealer (SD), or to continue to provide clearing services to clients, in the case of a futures commission merchant (FCM). If capital costs are too expensive, firms will restrict certain business activities, end unprofitable business lines, or, in some cases, exit the swaps or futures markets altogether. As a result, over time, the swaps and futures markets will become less liquid, less accessible to end users, more heavily concentrated, and less competitive. These are not the hallmarks of a healthy financial system. This is why I have always regarded the finalization of capital requirements for SDs and FCMs to be the most consequential rulemaking of the post-crisis reforms.

I believe the final capital regulations for SDs and FCMs adopted today establish minimum capital requirements that will ensure the safety and soundness of these firms for years to come, through periods of economic growth and stability and through periods of market contraction and extreme volatility. They are appropriately calibrated to the true risks posed by an SD's or FCM's business and ensure these firms have the capital necessary to support their active participation in the markets and servicing of clients. They are also largely harmonized with the capital approaches of the prudential regulators and the Securities and Exchange Commission (SEC), which should reduce unnecessary burdens and facilitate compliance.

No rule is perfect. I expect there will be aspects of this rule that need to be revised or recalibrated in the future–and I specifically discuss some areas below which I would like to see revisited. Nevertheless, it is a common saying that you cannot build a great house without a solid foundation. I am confident that today's capital regulations provide that foundation and will support vibrant, healthy derivatives markets, with future Commissions able to build upon this progress in the years to come. I would like to highlight a few aspects of the final rule below.

The risk margin amount. We heard from many commenters that, of all the alternatives, the proposed eight percent risk margin amount would act not as a capital floor as intended, but rather as the primary driver of firms' capital requirements and as a potential binding constraint on their businesses. The final rule appropriately recalibrates the scope of products included in this calculation, while also adopting a risk margin amount percentage that is appropriately tailored to the capital approach elected by the firm. Specifically, the final rule maintains the existing minimum capital requirements for standalone FCMs, with those firms continuing to maintain minimum capital equal to or greater than 8% of the risk margin amount for customer futures and cleared swaps. For FCM-SDs, the final rule establishes a minimum capital requirement equal to or greater than (i) 8% of the risk margin amount for customer futures and cleared swaps, plus (ii) 2% of the risk margin amount for the FCM-SD's uncleared swaps. For non-FCM SDs that elect the Net Liquid Assets Approach, the Final Rule requires the firm to maintain minimum capital equal to or greater than 2% of the SD's uncleared swap margin. For non-FCM SDs electing either the Bank-Based Approach or the Tentative Net Worth Approach, the final rule establishes a minimum capital requirement equal to or greater than 8% of the firm's uncleared swap margin. For the reasons discussed below, I believe each of these adjustments from the proposal represents an improvement that more precisely tailors the capital requirements of a firm to its particular business and its selected capital approach.

I support the removal of a firm's cleared and uncleared security-based swaps (SBS) from the risk margin amount calculation. It is appropriate that the Commission maintain its historical approach and establish minimum capital requirements for registrants that are based upon products within the CFTC's jurisdiction. I am also very pleased that proprietary cleared futures and swaps were removed from the risk margin amount. FCMs, FCM-SDs, and SDs electing the Net Liquid Assets Approach are all subject to rigorous market and credit risk capital charges on these proprietary cleared positions. I believe these capital charges adequately account for the risk of these positions and there is no reason to account for them yet again in the firm's minimum capital requirement. Moreover, for SDs that elect one of the other capital approaches, I also believe it is appropriate to exclude proprietary cleared positions given that the SD's credit exposure on such positions is limited to either a clearing organization or to the FCM that carries the SD's account.

Finally, I also support the reduced 2% risk margin multiplier amount on uncleared swap margin for FCMs, FCM-SDs, and SDs electing the Net Liquid Assets Approach, while maintaining the 8% multiplier for other types of standalone SDs. Under the FCM capital rules and the Net Liquid Assets Capital Approach for standalone SDs, the types of capital that may be used to meet a firm's minimum capital requirement are significantly more conservative than the types of capital that may be used under the Bank-Based Capital Approach and the Tangible Net Worth Capital Approach. The Net Liquid Assets Approach is liquidity-focused and generally requires the firm to hold at least one dollar of highly liquid assets for each dollar of the firm's liabilities. As a result, when computing what qualifies as eligible capital under this approach, firms must subtract all illiquid assets, such as fixed assets and intangible assets. In contrast, the other capital approaches focus on the solvency of the firm and require the firms to maintain positive balance sheet equity. Under these approaches, firms are not required to subtract illiquid assets or fixed assets from their balance sheet equity. Given the significantly more restrictive standard for qualifying eligible capital under the Net Liquid Assets Approach, I think it is appropriate to lower the risk margin multiplier to 2% in order to minimize competitive disparities across the other two capital approaches.

The final rule also expresses the Commission's ongoing commitment to monitor, and if necessary, adjust, the risk margin percentage. This should only be done, however, with a wealth of data and a highly robust economic analysis. With the benefit of the financial reporting the Commission will soon receive from SDs, the Commission may be able to further refine this metric to promote consistency across the possible SD capital approaches.

Bank-based capital approach. In response to commenters, the final rule now permits firms to use a combination of common equity tier 1, additional tier 1, and tier 2 capital to meet its minimum capital requirements under both the 8% of risk-weighted assets and 8% of uncleared swap margin alternatives. In particular, with respect to the 8% of uncleared swap margin alternative, the rule does not limit the amounts of additional tier 1 or tier 2 capital the firm can use to meet the requirement. Because of this additional flexibility, the final rule requires firms electing this approach to satisfy all of the four possible minimum capital alternatives. The Commission will need to closely observe the impact of this change to ensure it does not create any competitive disadvantages for firms electing this approach. I anticipate that if additional data and analysis shows this outcome creates unintended consequences, the Commission will take action to address them.

Model approval process. I am also pleased with the model approval process established in the final rule, which allows the Commission to realize the benefits of the NFA's considerable expertise and resources. Once the Commission, or the Director of the Division of Swap Dealer and Intermediary Oversight (DSIO) pursuant to delegated authority, makes a determination that the NFA's model review process is comparable to the Commission's process, the NFA's approval of a model will satisfy the Commission's model approval requirement. In addition, for a firm utilizing a model that has already been approved by its relevant regulator, the final rule provides a process whereby, upon making certain representations, the firm can continue to use the model pending approval by the Commission or NFA. These steps help ensure that firms seeking to use models will be able to do so by the rule's compliance date.

Areas for further improvement.

As I noted above, no rule is perfect. I would like to briefly highlight three areas not addressed in this final rule that I hope the Commission will address in the future.

Standardized market risk capital charges. First, this final rule does not adjust any of the standardized market risk charges under Regulation 1.17. I believe that many of these standardized charges are too high given the liquidity and actual risks of the product. For example, the final rule applies a 20% notional standardized market risk charge on uncleared foreign exchange non-deliverable forwards. In contrast, the Commission's uncleared margin rules apply a 6% notional charge on these products for purposes of the standardized initial margin calculation. I hope that in the future the Commission can work with the SEC to recalibrate and update these charges to better reflect the risks of the underlying products.

Alternative forms of collateral. Second, I hope that with the benefit of experience and information received from financial reporting, the Commission will consider modifying its rules to recognize alternative forms of collateral, such as letters of credit or liens, provided by commercial end users that are exempt from clearing and margin requirements when computing credit risk charges. Alternative collateral arrangements are frequently used by SDs in commodity derivatives transactions with end users to create "right way" risk and can be effective means of managing the credit risk of certain derivatives transactions. I think it would be beneficial for the Commission's capital regime to recognize, as appropriate, the risk-reducing nature of these arrangements.

Net liquid assets approach. Third, I am also interested in continuing to explore commenters' suggestion that firms electing the Net Liquid Assets Approach be required to maintain tentative net capital in excess of the risk margin amount, as opposed to the current net capital requirement. I continue to have concerns that in periods of high volatility, the procyclicality of increasing margin requirements may cause unnecessary stress on these firms, as their capital charges for positions increase at the same time as their minimum capital requirement. I am interested in looking at possible adjustments that could be made to address this issue.

In closing, I believe the capital regime adopted today strikes the necessary balance between capital levels that protect firms from losses on certain products, and levels that allow firms to earn an economic benefit from servicing their customers' risk management needs through those products. There is a direct tradeoff between the amount of capital regulators require firms to hold to ensure firms' resilience and viability, and the amount of available capital firms have to deploy in financial markets to support the market's ongoing liquidity and health. The capital standards adopted today protect the safety and soundness of firms, while ensuring they can continue to service their clients and make markets.

I would also like to thank DSIO, in particular Tom Smith, for their thoughtfulness and tireless dedication to getting this rule right. It has truly been a pleasure to work with and learn from you throughout this process.

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