HEARING TO REVIEW THE IMPACT OF CAPITAL AND MARGIN REQUIREMENTS ON END-USERS

HEARING

BEFORE THE

SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT

OF THE

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HEARING TO REVIEW THE IMPACT OF CAPITAL AND MARGIN REQUIREMENTS ON END-USERS

THURSDAY, APRIL 28, 2016

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 1300 of the Longworth House Office Building, Hon. Austin Scott of Georgia [Chairman of the Subcommittee] presiding.

Members present: Representatives Austin Scott of Georgia, Lucas, LaMalfa, Davis, Kelly, Conaway (*ex officio*), David Scott of Georgia, Vela, and Kirkpatrick.

Staff present: Caleb Crosswhite, Darryl Blakey, Kevin Webb, Stephanie Addison, Faisal Siddiqui, John Konya, Matthew MacKenzie, Nicole Scott, and Carly Reedholm.

OPENING STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

The CHAIRMAN. Well, good morning. Thank you for joining the Commodity Exchanges, Energy, and Credit Subcommittee for today's hearing, which is the second in a series to examine the implementation of Dodd-Frank over the past 5 years. In February, we held our first hearing to talk about swap data standards and transparency. During today's hearing, we will talk about the unintended consequences of some of the most important regulations following the financial crisis, the new capital standards and margin requirements for banks, non-bank swap dealers, and other market participants.

On a fundamental level, derivatives markets exist for hedgers, for those businesses and people who have risks that they seek to manage. And on the Agriculture Committee, we often think about the businesses that serve the farm economy and their ability to manage the risks they shoulder on behalf of their agricultural clients. But there are producers, manufacturers, merchants, pensions, insurers, and other businesses across our country that face similar challenges managing their commodity, foreign exchange, interest rate, and credit risks.

While Congress has been explicit in its efforts to exempt these end-users from much of the regulatory burdens associated with Dodd-Frank, these rules could have impacts on end-users if they drive intermediaries, like futures commission merchants and swap dealers, from the markets. If this happens, hedgers will see their spreads widen, their fees increase, and liquidity fall.

Without question, the financial crisis could have been tempered with stronger capital rules and margin requirements. And today's hearing isn't about the purpose or need for capital and margin standards; instead, it is about the outsized consequences of small decisions made when designing these rules. These decisions, things like how to account for margin or the differences between cash and cash-equivalents, may seem small to regulators, but they will be deeply impactful to main street businesses that rely on derivatives markets to manage their risks.

Regulation is about choices. Each rulemaking is built from a thousand little decisions that are supposed to add up to a desired outcome. Over the past 5 years, financial regulators have been busy making a lot of decisions, but it isn't entirely clear if we are reaching the outcome that was intended.

Today, we will examine those decisions and compare the outcome to Congress' longstanding goal to protect end-users from bearing the burdens of the financial crisis. Protecting end-users does not need to be a zero-sum game. I believe we can both build resilient markets and protect end-users from unnecessary burdens.

I want to close by thanking our witnesses for the time they have spent preparing and traveling to be with us today. The Subcommittee appreciates your willingness to share your talents and expertise with us today.

[The prepared statement of Mr. Austin Scott follows:]

PREPARED STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

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With that, I'll turn to our Ranking Member, Mr. Scott, for any remarks he might have.

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OPENING STATEMENT OF HON. DAVID SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman. And I want to welcome all of our distinguished witnesses. We are looking forward to your expert testimony in this very, very important area of the impact of capital and margin requirements on end-users.

Today's hearing is very, very important, mainly to finding that right balance between high enough capital and margin requirements to keep the system safe, and low enough capital and margin requirements to ensure that the system is profitable for everyone in the industry.

Our Committee took particular and very great pains over the years to exempt end-users from the margin and capital requirements necessary to reform the derivatives markets, for the simple reason that the farmers, the ranchers, other end-users, manufacturers, did absolutely nothing to cause the financial crisis. And we feel, on our Committee, that it is our job to make sure that this spirit continues in any regulations in the future. They had nothing to do with the financial crisis, and that must always be taken into consideration.

Over the years, I have been very, very concerned about cross-border transactions, and I am very pleased with the ongoing work of Chairman Massad, who is doing a fine job over at the CFTC. But Chairman Massad has had a tough, tough battle in dealing with the issue of the European Union equivalency. And so I am looking forward very much to getting your evaluation of that, where you see the progress going, because if we do not solve this situation with the equivalency issue with the European Union, it is going to put our end-users, our manufacturers, our clearinghouses at a very, very serious competitive disadvantage.

And so I look forward to this hearing, and I want to thank Chairman Scott for, again, pulling together a very, very timely hearing. We are dealing on the derivatives case with an $700 trillion piece of the world's economy. Many people do not know it is that large. That is huge, and it is growing exponentially every single day, and that is why this hearing is very important.

And I thank you, Mr. Chairman, and I yield back.

The CHAIRMAN. Thank you, Mr. Scott.

I would like to welcome our witnesses to the table. We have the Honorable Walter Lukken, President and Chief Executive Officer of the Futures Industry Association in Washington, D.C., we have the Honorable Scott O'Malia, Chief Executive Officer, International

Swaps and Derivatives Association, Incorporated, New York, New York; Mr. Thomas Deas, representative of the Center for Capital Markets Competitiveness and Coalition for Derivatives End-Users; and Mr. Tyler Gellasch, Founder of Myrtle Makena, LLC, Homestead, Pennsylvania.

Mr. Lukken, please begin when you are ready.

STATEMENT OF HON. WALTER L. LUKKEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. LUKKEN. Mr. Chairman, Ranking Member Scott, and Members of the Subcommittee, thank you for this opportunity to testify on the impact of margin and bank capital on the cleared derivatives markets.

I am President and CEO of FIA, a trade association for the futures, options, and centrally cleared derivatives markets. Both margin and bank capital play an important role in protecting the safety and soundness of the financial system. Since the financial crisis, their roles have been heightened with the G20 leaders' commitment to both enhance bank capital, and require the clearing, and thus, margining of standardized OTC products through regulated clearinghouses.

While capital and margin are both tools in protecting the financial system, it is important to distinguish the two, as each serves a specific function in meeting this important goal.

Bank capital is the amount of funds that a banking institution holds in reserve to support its banking activities. Required by national banking regulators under international standards set by the Basel Committee on Bank Supervision, bank capital serves as a stable financial cushion to absorb unexpected losses by banks. Margin, on the other hand, aims to protect the safety and soundness of the futures and cleared derivatives markets, rather than specific institutions. Customers that utilize the futures or cleared derivatives markets to hedge their risks are required to clear such transaction through a clearinghouse, and in order to do so, must post margin with a clearing member. The clearing member, in turn, manages this collection of margin from its customers, and guarantees the customers' transactions with a clearinghouse. The customers' margin is simply a performance bond that ensures customers make good on their transactions, which offsets the clearing member's exposure to the clearinghouse.

Many of the largest clearing members are also affiliated with prudentially regulated banks, and thus, are required to hold sufficient capital to ensure their firm, and thus, the system, is protected. As large financial institutions, these banks are subject to both CFTC regulation for their future commission merchant clearing business, as well as bank capital regulations under the oversight of the Federal Reserve, the FDIC, and the OCC. These U.S. bank regulators, consistent with standards set by the Basel Committee, are now implementing a new type of capital provision known as the leverage ratio. Part of the goal of the leverage ratio is to set a simple, non-risk-based floor for capital, including measuring the exposures arising from futures options and other derivatives transactions. Unfortunately, the leverage ratio fails to properly recognize that customer margin posted to a bank-affiliated clearing member offsets the bank's actual exposure to the clearinghouse.

The very nature of customer margin is to reduce the exposure of losses to the clearing member and the clearinghouse. In recent years, the CFTC, under your oversight, has made significant improvements to enhance customer margin to ensure it is always the first line of protection to offset losses during a default. If left unfixed, the leverage ratio will result in an inaccurate measurement of the actual economic exposure of the bank, and assign unwarranted capital charges on its clearing business. This will lead to higher costs for end-users and hedgers in our markets. Given these new capital constraints, bank clearing members are already beginning to limit the amount and types of clients that they accept to clear. We also believe the leverage ratio will lead to further consolidation among clearing members, resulting in fewer players supporting the safety and soundness of the clearinghouse.

In the U.S., clearing members have decreased from 94 clearing firms 10 years ago, to only 55 today. While there are several factors contributing to this consolidation, capital has been recently cited by several clearing member banks who have now exited the clearing business.

Perhaps the most concerning consequence for this Committee surrounds the leverage ratio's impact on a clearinghouse's ability to move or port client positions from a defaulting clearing member to another healthy clearing member during a crisis. If porting cannot be achieved due to capital constraints, clearinghouses will be forced to liquidate in a fire sale client positions during volatile market conditions, adding unnecessary stress to an unstable marketplace. After all, the ability of clearinghouses to move customer positions during the failure of Lehman Brothers in 2008 is one of the fundamental reasons that policymakers in the G20 determined to expand clearing to OTC products.

In closing, I would encourage the U.S. regulatory community to work together through the Basel process in determining how our margin and bank capital regulations can work in context. Without a fix, recent efforts by the G20 to increase the use of clearing may be in jeopardy, and customers in the futures and cleared swaps markets may face higher costs and less access to these risk management markets.

Thank you very much, and I look forward to your questions.

[The prepared statement of Mr. Lukken follows:]

PREPARED STATEMENT OF HON. WALTER L. LUKKEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Introduction

Chairman Scott, Ranking Member Scott, and Members of the Subcommittee, thank you for the opportunity to discuss capital and margin matters impacting the derivatives industry. I am the President and Chief Executive Officer of FIA. FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system and to promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members help reduce systemic risk in global financial markets.

Clearing ensures that parties to a transaction are protected from the failure of a buyer or seller to perform its obligations, thus minimizing the risk of a counterparty default. The clearinghouse is able to take on this role because it is backed by the collective funds of its clearing members who also guarantee the performance of their clients to make good on their transactions. To protect against default, clearinghouses require that all transactions are secured with appropriate margin. Clearing members, acting as agents for their customers, collect this margin and segregate it away from their own funds as required by the Commodity Exchange Act. They have long performed this function for futures customers, who have historically been required to clear their transactions. More recently, under the "Dodd-Frank Act" (Dodd-Frank) in the U.S. and the "European Market Infrastructure Regulation" (EMIR) in Europe, policymakers determined to extend the clearing requirement beyond futures and options to certain over-the-counter swaps, and as such, the role of the clearing member has expanded. Despite this expansion, over the 10 year period between 2004 and 2014, the clearing member community in the U.S. has decreased from 190 firms to 76 firms.

While there are several factors contributing to this consolidation, today I want to focus on how recent Basel III capital requirements for prudentially regulated clearing members are lessening clearing options for end-user customers who use futures and cleared swaps to manage their business risks. These capital requirements have made it difficult for many clearing member banks to offer clearing services to their clients—a result that seems at odds with recent efforts by the Group of 20 nations (G20) to increase the use of clearing as a counterparty risk mitigation tool.

At issue is the Basel leverage ratio, a measurement tool used by banking regulators to determine the amount of leverage that should be backed by capital. Unfortunately, the Basel leverage ratio fails to properly recognize that client margin posted to a bank-affiliated clearing member belongs to the customer, and is provided by the customer to offset the bank's exposure to the clearinghouse. It does not belong to the bank. The assumption that this customer margin can be used by the bank without restriction runs counter to the Commodity Exchange Act and Commodity Futures Trading Commission (CFTC) regulations.

The amount of capital under the Basel leverage ratio required to be held for clearing is estimated between $32 Billion and $66 billion. Once more products are subjected to clearing under the new G20 clearing mandates those estimates increase to a range of $126 billion and $265 billion. End-user clients are beginning to feel the impacts of these costs, which are likely to increase over time as Basel capital requirements are fully implemented.

Background—Basel Leverage Ratio

One of the central reforms to bank capital requirements following the financial crisis was the decision by the Basel Committee on Bank Supervision (Basel Committee) to implement a new type of leverage ratio on a global basis. In January 2014, the Basel Committee finalized its leverage ratio standard. Based on this standard, the Basel leverage ratio was implemented in the United States by the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC). While the leverage ratio will technically not become a legally binding requirement on the largest U.S. banks until January 2018, it already is effectively being implemented by the banks as a result of mandatory reporting requirements and market expectations. Other jurisdictions, including the European Union, Japan and Switzerland, are also in the process of implementing leverage ratio standards based on the Basel leverage ratio.

This Basel leverage ratio would require a bank to hold a minimum amount of capital relative to not only its on-balance sheet assets, but also to its off-balance sheet exposures arising from futures, options, and other derivative transactions. The Basel leverage ratio was designed to be "a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements".[1] While FIA supports the goals of stronger capital requirements and recognizes the leverage ratio of the Basel III requirements as an important backstop to keep leverage in check, we also believe the Basel leverage ratio should accurately reflect the actual economic exposures of the banking entity.

As currently measured, we believe the exposure measure under the leverage ratio is artificially inflated to capture more than actual economic exposures with respect to cleared derivatives transactions. In particular, this real and significant overstate-

[1] Basel Committee on Banking Supervision—*Basel III leverage ratio framework and disclosure requirements,* January 2014.

ment of actual economic exposure arises from the failure of the Basel leverage ratio measure to recognize the exposure-reducing effect of segregated client margin posted to the bank in the limited context of centrally cleared derivatives transactions. The inflated economic exposure results in unwarranted capital costs.

Failure to Recognize Customer Margin

The Basel leverage ratio has failed to properly consider the exposure-reducing effect of customer margin posted to a prudentially-regulated banking entity that is acting as an agent to facilitate derivatives clearing services on behalf of the client. Such customer margin is posted to a bank-affiliated clearing member to ensure that the clearing member's exposure to the clearinghouse is lessened while also allowing the customer access to the cleared derivatives markets' risk management tools. That is, an end-user that utilizes the futures market to hedge its business risks is required to clear such a transaction through a clearinghouse, and in order to do so it must post margin through a clearing member for the purpose of offsetting exposure to the clearinghouse. Oftentimes, the clearing member is affiliated with a bank. Furthermore, Congress, and more specifically this Committee, through the Commodity Exchange Act, requires the clearing member to treat margin received from a customer for cleared derivatives transactions as belonging to the customer and segregated from the clearing member's own funds. Yet the Basel leverage ratio does not recognize this margin for its intended purpose—these are customer funds provided specifically to offset the bank-affiliated clearing member's exposure in their obligation to pay the clearinghouse on behalf of the customer. Such customer margin should therefore be considered an offset in determining the bank's exposure.

Unlike making loans or taking deposits, guaranteeing client trades exposes the bank to losses only to the extent that the margin collected is insufficient to cover the clients' obligations. Indeed, to make sure that such margin is always available to absorb losses arising from the customer's transaction, CFTC rules require that it be posted in the form of either cash or extremely safe and liquid securities such as U.S. Treasuries and that such margin be clearly segregated from the bank's own money. These are customer funds provided specifically by the customer to offset the clearing member's exposure arising from its obligation to pay the clearinghouse on behalf of the customer. Such customer margin should therefore be considered as an offset in determining the bank's exposure. That is, the very nature of initial margin posted by a derivatives customer is solely exposure-reducing with respect to the clearing member's cleared derivatives exposure.

Given these longstanding regulatory requirements and the exposure-reducing function of margin, it stands to reason that the Basel leverage ratio should recognize segregated client margin as reducing a clearing member bank's actual economic exposure to a clearinghouse for purpose of measuring exposure. Nevertheless, the Basel leverage ratio does not recognize this plainly exposure-reducing effect when calculating the clearing member's exposure.

Recently the Basel Committee has proposed to refine its leverage ratio's calculation of exposure for derivatives. While the Basel Committee did not propose to include an offset for initial client margin in cleared derivatives transactions, the Committee requested information on whether the Basel leverage ratio's failure to recognize client margin will harm the cleared derivatives market. We plan to submit a comment letter with data showing that the failure to recognize the exposure-reducing effect of initial margin will adversely impact clearing members' business, customers' access to cleared derivatives, competition, and systemic risk. In fact, many of these effects can already be observed in the market.[2]

To be clear, this has nothing to do with trades undertaken by banks on their own account. Our concerns solely relate to trades that banks clear on behalf of their clients.

Negative Consequences

Left unchanged, the Basel leverage ratio will undermine recent financial regulatory reforms by discouraging banks from participating in the clearing business, thereby reducing access to clearing and limiting hedging opportunities for end-users. The failure of the Basel leverage ratio to recognize the exposure-reducing effect of segregated margin will substantially and unnecessarily increase the amount of required capital that will need to be allocated to the clearing businesses within these banking institutions. Banks will be less likely to take on new clients for derivatives clearing. Such a significant increase in required capital will also greatly increase

[2] *See, e.g., SIFMA AMG Submits Comments to the Basel Committee on Banking Supervision on Higher Prices and Reduced Access to Clearing Experienced by Asset Managers* (Feb. 1, 2016), available at *http://www.sifma.org/issues/item.aspx?id=8589958563*.

costs for end-users, including pension funds and businesses across a wide variety of industries that rely on derivatives for risk management purposes, including agricultural businesses and manufacturers. As a result, market participants may be less likely to use cleared derivatives for hedging and other risk management purposes or, as a result of mandatory clearing obligations for some derivatives, some market participants may not be in a position to hedge their underlying risks.

FIA represents bank and non-bank clearing members and I can assure you that this situation is not one that will benefit the non-bank clearing firm. In fact, many non-bank clearing members—those clearing members not subject to Basel III capital requirements—have weighed in to explain their inability to assume the clearing volume currently done through banks due to their own balance sheet constraints. Moreover, these non-bank clearing members are concerned about the broader market impacts that may arise as a result of fewer access points to the cleared derivatives markets. This harms farmers seeking to manage commodity price fluctuations, commercial companies wishing to lock in prices as they distribute their goods, and pension funds using derivatives to enhance workers' retirement benefits. The negative impacts to the real economy are significant.

In addition, the liquidity and portability of cleared derivatives markets could be significantly impaired, which would substantially increase systemic risk. The lack of an offset would severely limit the ability of banks to purchase portfolios of cleared derivatives from other distressed clearing members—including distressed banks. This will leave clearinghouses and customers of any failing clearing member with an added strain during an already stressful situation. Moreover, as the levels of margin required by clearinghouses increase in times of stress, Basel leverage ratio capital costs will correspondingly increase, aggravating the constraint on portfolio purchases. Such a constraint on providing liquidity to stressed markets would accelerate downward price pressure at exactly the wrong moment, thereby increasing risk to the system.

Significantly increased capital costs will also likely result in market exit by some derivatives clearing members that will find the business no longer economically viable in terms of producing a sufficiently high return on equity. The resulting industry consolidation would increase systemic risk by concentrating derivatives clearing activities in fewer clearing member banks and potentially reduce end-user access to the risk mitigation benefits of central clearing.

The consequences I have just outlined are fundamentally inconsistent with market regulators' global policies designed to enhance the appropriate use of centrally cleared derivatives. In various speeches CFTC Chairman Massad has expressed concern about the Basel leverage ratio's treatment of initial margin for client cleared derivatives and the resulting declining population of clearing members as well as systemic concerns related to the portability of client positions and margin funds.

Conclusion

While we were disappointed the Basel Committee's consultation did not include a client margin offset, we were encouraged that the Basel Committee identified the issue in its consultation, and is seeking further evidence and data on the impact of the Basel leverage ratio on client clearing and on banks' business models during the consultation period. FIA is working with its members and other trade associations on its response to the Basel Committee's proposed revisions, including obtaining evidence and data on the impact of the standard.

As part of our response to the Basel Committee, we will identify a number of options to recognize the risk-reducing effects of initial margin. These proposals will be consistent with the goals of the Basel Committee in establishing the Basel leverage ratio. We are hopeful the Basel Committee will recognize our concerns. FIA appreciates the Subcommittee's interest in ensuring that banking regulations do not run counter to the well-established benefits for clients of cleared futures or the new G20 clearing obligations for swaps.

STATEMENT OF HON. SCOTT D. O'MALIA, CHIEF EXECUTIVE OFFICER, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NY

Mr. O'MALIA. Chairman Scott, Ranking Member Scott, and Members of the Subcommittee, thank you for the opportunity to testify here today.

I would like to thank the Committee for holding this timely hearing to discuss the ramifications of two major reforms; bank capital and liquidity rules, and the margin requirements for non-cleared trades. Both will have a massive and profound impact on the derivative end-users.

In my testimony, I would like to explain the findings ISDA has produced to determine the cost impact of the capital rules, and will emphasize the need for a comprehensive and cumulative impact assessment. I will also provide an update on the implementation of the margin rules, and the steps ISDA is taking to ensure these are implemented in a cost-effective manner.

Substantial progress has been made to ensure that the financial system is more robust. The implementation of Basel 2.5 and Basel III means banks now hold more and better quality capital than ever before. An additional capital surcharge is being implemented for systemically important banks, and a resolution framework is being put in place to wind down failed banks without taxpayer assistance. This is on top of the global derivatives market infrastructure reforms, including data reporting, trading, and clearing.

While many aspects of the new rules have been finalized, core aspects of the Basel reform agenda, such as the leverage ratio, net stable funding ratio, fundamental review of the trading book, are still evolving. As it stands, these reforms look to significantly increase costs for banks, and may negatively impact the liquidity of these markets and the ability of banks to lend and provide crucial hedging services to corporate pension funds and asset managers.

Recent ISDA analysis suggests that the compliance with just one of the rules, the NSFR, will require the banking industry to raise additional long-term funding. We are concerned that the cumulative impact of the different parts of the banking capital reform are still unknown, and it is our belief that regulators shoulder undertake a cumulative impact assessment, *posthaste.* Given the continuing concerns about economic growth and job creation, legislators, supervisors, and market participants need to understand the cumulative impacts of the regulatory changes before they are implemented.

When it comes to the health of the global economy, I think the old tailor's saying holds true: measure twice and cut once. At this moment, we are cutting our cloth in the dark. ISDA has been working hard to understand the impacts of the individual rules, and over the past year we have conducted eight impact studies. In each case, these studies have indicated sizeable increases in capital, on top of the increases that have already occurred as part of Basel III. We have also found the impact was not uniform across all banks, with certain businesses hit particularly hard. One good example is the leverage ratio and its effect on client clearing business. As it stands, the rule fails to recognize the risk-reducing impact of the initial margin posted by customers, and this has proved detrimental to the economics of client clearing, and is in direct conflict with the G20 objectives of central clearing.

Now let me turn to the final rules regarding the margin for non-cleared trades. As I noted earlier, these rules will have a significant cost impact on non-cleared products. According to the analysis published by the CFTC, the industry may have to set aside over $300 billion of initial margin to meet these requirements. ISDA has worked closely with the market at the global level to prepare for implementation, and I am proud to say that ISDA and its members have accomplished a great deal. First, we have established a standard initial margin model called ISDA SIMM, which all participants can use to calculate the initial margin requirements. This is nothing short of revolutionary for the over-the-counter market. Second, we have worked to draw up a revised margin documentation that is compliant with the collateral and segregation rules. Third, we have established a robust governance structure to allow for the necessary evolution of the model, and to provide regulators complete transparency into the model development process. Despite these efforts, challenges remain. The deadline for implementation of the initial margin requirements for the largest banks is September 2016. The variation margin, big bang, is set for March of 2017, which affects all market participants.

There are still a few important items that need to fall into place to ensure that the market can move forward confidently. First, regulators need to send a clear signal that the ISDA SIMM is fit for purpose, and banks can confidently begin to apply this model before the 2016 deadline. Second, regulators must finalize the cross-border rules, which will result in the recognition of comparable jurisdictions. To date, the CFTC cross-border margin rules have not been approved, and if it is not rectified as soon as possible, the hard work to unify the rules under the Basel Committee IOSCO at that level will be undermined. In addition, ISDA will not be able to complete the necessary documentation that will assist dealers in determining whether their clients fall within scope of the margin rules by the time the rules go final.

And I appreciate the Committee's interest in ensuring that the G20 reforms are implemented in a cost-effective manner, and this ensures that end-users have access to global capital markets and derivatives markets. You can be confident that ISDA will continue to work to develop the data on the capital rules to contribute to a safe but cost-effective capital structure, as well as facilitate the transition to a new margin regime that is fully transparent and effective.

I am happy to answer any of your questions. Thank you.

[The prepared statement of Mr. O'Malia follows:]

PREPARED STATEMENT OF HON. SCOTT D. O'MALIA, CHIEF EXECUTIVE OFFICER, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NY

Chairman Scott, Ranking Member Scott, and Members of the Subcommittee. Thank you for the opportunity to testify today.

I would like to thank the Committee for holding this timely hearing to discuss the ramifications of the last two rule-sets associated with the Group of 20 (G20) derivatives reforms—bank capital and liquidity rules, and margin requirements for non-cleared derivatives trades. Both will have a profound impact on derivatives end-users.

The capital and liquidity rules, which are being developed by the Basel Committee on Banking Supervision, will be implemented through to 2019. The margin rules kick in from September this year, and will be fully phased in by 2020.

My testimony today will address these two important rules. I will explain the findings ISDA and its members have produced to determine the cost impact of individual capital rules, and will emphasize the need for a comprehensive cumulative impact assessment encompassing all elements of the bank capital and liquidity reforms. I will also provide a progress update on the implementation of the margin rules, and the steps ISDA is taking to help regulators and market participants comply with them in a cost-effective and transparent manner.

Executive Summary

Over the past 6 years, substantial progress has been made to ensure the financial system is more robust. The implementation of the Basel 2.5 and Basel III capital and liquidity reforms means that banks now hold more and better quality capital than ever before. The amount of common equity capital at the largest U.S. banks has more than doubled since the crisis. Liquidity requirements are also being phased in to reduce reliance on short-term borrowing and bolster reserves of high-quality liquid assets.

This is on top of derivatives market structure reforms that have been introduced by the Commodity Futures Trading Commission (CFTC) and, to some extent, the Securities and Exchange Commission (SEC), which include swap dealer registration, data reporting, trading and clearing mandates. In addition, a resolution framework is now being put in place to manage and allow for the orderly resolution of a bank without the need for taxpayer assistance.

But while many aspects of the new rules have been finalized and are already implemented, core elements of the Basel reform agenda, such as the leverage ratio, net stable funding ratio (NSFR) and the Fundamental Review of the Trading Book (FRTB), are still evolving.

As it stands, these reforms look set to significantly increase costs for banks, and may negatively impact the liquidity of derivatives markets and the ability of banks to lend and provide crucial hedging products to corporate end-users, pension funds and asset managers.

We are concerned that the overall effect of the different parts of the bank capital reform program is unknown, and it is our belief that regulators should undertake a cumulative impact assessment post haste. When it comes to the health of the global financial system and economy, I think the old tailor's saying holds true—measure twice, cut once.

At the moment, we are cutting our cloth in the dark. Given continuing concerns about economic growth and job creation, legislators, supervisors and market participants need to understand the cumulative effect of the regulatory changes before they are fully implemented so we can prevent any significant negative impact to the real economy.

ISDA has been working hard to understand the impact of the individual elements of the rules. Over the past year, we have conducted eight impact studies on new capital and liquidity measures. In each case, those studies have indicated sizeable increases in capital or funding requirements for banks, on top of the increases that have already occurred as part of Basel III.

There is literally no one who has any clear idea what the aggregate impact of each of these rules will be. So far, each new measure has been looked at in isolation, without considering how it will interact with other parts of the capital framework.

Significantly, ISDA's analysis shows the impact is not uniform across all banks, with certain business lines hit particularly hard. We therefore believe it is crucial that policy-makers not only view the final capital rules through the prism of the overall impact on capital levels, but also assess the effect on individual business lines.

That's because the impact of the new rules on individual business units or product areas could be disproportionate, and the difference between a bank choosing to stay the course or exit the business. One good example is the leverage ratio and its effect on client clearing businesses. As it stands, the rule fails to recognize the risk-reducing effect of initial margin posted by the customer. This has proved detrimental to the economics of client clearing and is in direct conflict with the G20 goals to encourage central clearing of derivatives.

Having provided my high-level recommendations on the capital and liquidity rules, I'd now like to turn to the final rules regarding margin for non-cleared derivatives.

As I noted earlier, these rules will have a significant cost impact on non-cleared derivatives trades. According to analysis published by the Federal Reserve and the CFTC, the industry may have to set aside over $300 billion in initial margin to meet the requirements.

ISDA has worked closely with the market at a global level to prepare for implementation. I am proud to say ISDA and its members have accomplished a great deal.

First, we have developed a standard initial margin model called the ISDA SIMM that all participants can use to calculate initial margin requirements. In a bilateral setting, having a central resource that can do this and resolve any disputes over initial margin calls will be vitally useful for all counterparties.

Second, we've worked to draw up revised margin documentation that is compliant with the rules, and we're developing a protocol to allow market participants to make changes to their outstanding margin agreements as efficiently as possible. This is essential for all market participants to exchange margin in an orderly and legally compliant way.

Third, we have established a completely transparent and robust governance structure to allow for the necessary evolution of the model, providing both regulators and market participants the confidence that the model is appropriately updated and available for regulatory review and validation.

Despite these efforts, challenges remain. In particular, there are concerns about how the margin rules will work on a cross-border basis. The requirements were drawn up at a global level by the Basel Committee and the International Organization of Securities Commissions (IOSCO) before being implemented by national regulators. That's a process we support, and has meant the various national rules are largely consistent.

But differences do exist in the detail, in everything from scope of the products and entities covered by the rules to settlement times. This means it is vital that substituted compliance decisions are based on broad outcomes, rather than rule-by-rule comparisons with overseas requirements.

The deadline for implementation of the initial margin requirements for the largest banks (Phase I) is approaching on September 1, 2016. Following this date is the variation margin 'big bang' on March 1, 2017, which affects all market participants.

There are a few items that need to fall into place to ensure the market can move forward confidently with these last rules.

First, regulators need to send a clear signal that the ISDA SIMM is fit for purpose and banks can confidently begin to apply this model to comply with the September 2016 deadline.

Second, the CFTC must finalize its cross-border margin rules to ensure substituted compliance determinations can be made for overseas rules that achieve similar outcomes.

These substituted compliance decisions also should be taken quickly. Another 3 year wait for a substituted compliance or equivalence determination, as happened with the U.S./EU central counterparty (CCP) equivalency standoff, will hobble cross-border trading and further contribute to the fragmentation of global derivatives markets.

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I'd like to address each of these issues in more detail. Before I do, I would like to stress that ISDA supports the intention of the capital reforms to strengthen the resilience of the banking system. We also support the safe and efficient use of collateral to reduce risk in the bilateral derivatives market.

In fact, ISDA has worked with its members to drive this objective for most of its 31 year history. We've also worked closely with our members over the past 3 years to develop the infrastructure, technology and documentation to ensure the new margin rules for non-cleared derivatives can be implemented with minimum disruption to the market.

This is consistent with our mission statement: ISDA fosters safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. In fact, our strategy statement was recently modified to emphasize the importance of ensuring a prudent and consistent regulatory capital and margin framework.[1]

Since ISDA's inception, we have worked to reduce credit and legal risks in the derivatives market and to promote sound risk management practices and processes. This includes the development of the ISDA Master Agreement, the standard legal agreement for derivatives, as well as our work to ensure the enforceability of netting. We currently have more than 850 members in 67 countries. Over 40% of our members are buy-side firms.

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While ISDA represents the full cross-section of the derivatives market, including banks, exchanges, CCPs, asset managers, pension funds and supranationals, I would like to focus on the impact the capital rules will have on the banking sector.

Banks play a hugely significant role in the U.S. economy. They provide access to capital markets and underwrite debt and equity issuances to ensure companies can raise the financing they require to expand their businesses. They provide the hedging and risk management tools that enable U.S. firms to export their goods and services worldwide.

[1] ISDA mission and strategy statement: *http://www2.isda.org/about-isda/mission-statement/*.

They provide loans to companies large and small to ensure they have the capital they need to grow. According to recent figures from the Federal Reserve, banks currently have more than $2 trillion in commercial and industrial loans outstanding. To put that into context, it's roughly the same as the GDP of India. That translates into business investment, jobs and economic growth.

Banks also provide risk management services to those end-user companies, creating balance-sheet stability and allowing them to improve their planning. The certainty that hedging provides gives companies the confidence to invest in future growth and create new jobs.

Given the vital role that banks play in our economy, it's important they are safe and resilient. And, since the crisis, a huge amount of effort has gone into making sure that they are.

Banks now have to hold much higher levels of capital than before the crisis—and that capital is required to be of much higher quality, ensuring it is able to absorb losses. Banks have also had to introduce new capital conservation and countercyclical buffers, along with the implementation of a capital surcharge for systemically important banks. They now have to explicitly hold capital against the risk of a derivatives counterparty default, and they are in the process of rolling out new liquidity requirements that are meant to ensure they have a sufficient stock of assets to withstand a sudden shock in market liquidity.

According to the Federal Reserve, common equity capital at the largest eight U.S. banks has more than doubled since 2008, representing an increase of nearly $500 billion.[2] Their stock of high-quality liquid assets has also increased considerably, rising by approximately ⅔.

While significant improvements have already been made to the capital framework, a number of other reforms are either in the consultation phase or have been finalized but not yet implemented. Given the increases in capital that have already occurred since the crisis, policy-makers have recently been at pains to stress that further refinements should not result in a significant rise in capital across the banking sector.

In recent months, that message has been given by the G20,[3] the Financial Stability Board (FSB),[4] the Group of Central Bank Governors and Heads of Supervision (GHOS),[5] and the Basel Committee itself.[6]

ISDA entirely supports this stance. While changes were needed in the wake of the financial crisis to bolster the capital held by banks, it's important this capital is commensurate with risk. Asking banks to hold ever higher amounts of capital could strangle bank lending, their ability to underwrite debt and equity, and their willingness to provide hedging services to end-users. An economy requires capital and investment to thrive. Choke off the supply of financing, and economic growth will be put at risk.

Unfortunately, recent studies by ISDA suggest that several new measures will result in increases in capital. While each of the increases on their own may not result in a significant increase in capital across the banking sector, they do have an impact on certain business lines that are important for end-user financing and hedging.

Crucially, though, it's currently not possible to say for sure how much the new measures, in aggregate, will increase capital requirements across the banking sector. That's because an overall impact study has not been conducted on the full set of capital, liquidity and leverage rules. While the potential for such a study has been limited during the rule-development phase, we believe a comprehensive analysis is now possible and necessary in order to help regulators and policy-makers calibrate the rules at an appropriate level.

ISDA would like to highlight several areas that we believe warrant further attention.

Leverage Ratio

The central clearing of derivatives transactions is a key objective of the G20 derivatives reforms and a central tenet of the Dodd-Frank Act. The leverage ratio is

[2] Federal Reserve Chair Janet L. Yellen, Before the Committee on Financial Services, U.S. House of Representatives, Washington, D.C., November 4, 2015: *http://www.federalreserve.gov/newsevents/testimony/yellen20151104a.htm*.

[3] G20 Finance Ministers and Central Bank Governors Meeting, Shanghai, February 27, 2016: *http://www.g20.utoronto.ca/2016/160227-finance-en.html*.

[4] FSB to G20 Finance Ministers and Central Bank Governors, February 22, 2016: *http://www.fsb.org/wp-content/uploads/FSB-Chair-letter-to-G20-Ministers-and-Governors-February-2016.pdf*.

[5] Basel Committee press release, January 11, 2016: *http://www.bis.org/press/p160111.htm*.

[6] Basel Committee press release, March 24, 2016: *http://www.bis.org/press/p160324.htm*.

a non-risk based measure meant to complement risk-based bank capital requirements, and is designed to act as a backstop.

In its current form, however, the leverage ratio acts to disincentivize clearing. That's because it doesn't take client margin into account when determining the exposures banks face as a result of their client clearing businesses.

Senior figures in the regulatory community already recognize this. In December last year, Mark Carney, the Governor of the Bank of England, noted that the current stance of the leverage ratio makes clearing more challenging, and "increases concentration, reduces diversity and reduces financial stability for the system".[7] Timothy Massad, Chairman of the CFTC, has also echoed these sentiments.[8]

Properly segregated client cash collateral is not a source of leverage and risk exposure. However, as currently proposed, the rule would require firms to include these amounts in their calculations. This is unreasonable, as cash collateral mitigates risk. Strict rules exist to protect this collateral and ensure it cannot be used to fund the bank's own operations. Instead, it can only be used to further the customer's activities or resolve a customer default. As such, it acts to reduce the exposure related to a bank's clearing business by covering any losses that may be left by a defaulting client.

The failure of the leverage ratio to recognize the risk-mitigating effect of segregated client cash collateral could mean the amount of capital needed to support client clearing services increases considerably. The end result is that the economics of client clearing would make it extremely difficult for banks to provide this service and may cause them to pull out of the market, harming liquidity and limiting opportunities for end-users. This perverse outcome runs counter to the objective set by the G20, as implemented by Congress in the Dodd-Frank Act, to encourage central clearing.

ISDA has been drawing attention to this issue for some time, and the Basel Committee recently reopened the leverage ratio for consultation. As part of that consultation, the Basel Committee said it would collect data to study the impact of the leverage ratio on client clearing, with a view to potentially recognizing the exposure-reducing effect of initial margin posted by the client.

We welcome that development—although it is disappointing that the consultation will not consider the recognition of initial margin more broadly. We will work with members to provide the necessary data for this consultation. Clearing has become a significant part of the derivatives market, so it's incredibly important we get this measure right.

Trading Book Capital

The Basel Committee's FRTB is intended to overhaul trading book capital rules, replacing the mix of measures currently in place with a more coherent set of requirements. The changes were primarily targeted at improving coherence and consistency in the market risk framework. Market risk capital levels were raised significantly in the immediate aftermath of the crisis through a package of measures known as Basel 2.5. Raising capital further was not a stated objective of the FRTB.

Nonetheless, the Basel Committee has estimated the revised market risk standard would result in a weighted mean increase of approximately 40% in total market risk capital requirements. But that estimate is based on a recalibration of quantitative-impact-study data from an earlier version of the rules.

To better understand the effect, ISDA recently led an industry impact study based on data submitted by 21 banks. The industry results show that market risk capital will increase by at least 50% compared to current levels. However, this assumes all banks will receive internal model approval for all their trading desks. If all banks do not receive internal model approval for all trading desks, market risk capital would increase by 2.4 times. ISDA believes the end result will be somewhere in between.

Importantly, our study shows a massive cliff effect between standardized and internal models. If a particular desk were to lose regulatory approval to use internal models, capital requirements could immediately increase by multiple times. To give an example, losing internal model approval under the new rules would result in a 6.2 times increase in capital for FX desks and a 4.1 times increase for equity desks.[9]

Let me put that into context. Both FX and equity desks are important for end-user hedging and financing. FX trades allow U.S. companies operating or selling

[7] *Risk,* December 8, 2015: *http://www.risk.net/risk-magazine/news/2438242/carney-leverage-ratio-could-limit-clearing-benefits*.

[8] *http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-31*.

[9] These numbers exclude the so-called residual risk add-on, non-modellable risk factors and diversification across risk classes under internal models.

products in foreign countries to obtain financing in the U.S., which is typically more cost effective, and enable them to limit their exposure to foreign currency fluctuations. A sudden, overnight increase in capital requirements of between four and six times could stymie the ability of a bank to continue offering that service, at least in the short-term. We believe these rules should be carefully reconsidered to prevent lasting harm to actors in the real economy. (Please see *Annex I* for a more in-depth consideration of the impact of the FRTB.)

ISDA welcomes the extensive engagement the Basel Committee has had with the industry during the development phase of the trading book rules. We have proposed technical modifications and refinements throughout the process, and will continue to provide feedback during the monitoring phase.

Net Stable Funding Ratio

The NSFR is designed to ensure banks fund their activities with sufficiently stable sources of funding to avoid liquidity mismatches.

ISDA supports the intention of this rule. One of the issues raised by the financial crisis was the gap between short-term borrowings of banks *versus* their long-term lending. Even ahead of this rule coming into effect in January 2018, banks have significantly reduced their reliance on short-term wholesale financing.[10]

Nonetheless, we are concerned about the impact of the NSFR on the derivatives business, and believe the rule as it stands will hinder the ability of end-users to access hedging products.

In particular, the rule currently requires banks to hold extra stable funding equal to 20% of derivatives liabilities, without taking into account any margin posted. This measure was not offered for public notice and comment, and the impact was never studied. ISDA understands the need to capture contingent liquidity risks, but the rule in its current form is overly conservative and duplicates other measures that already capture contingent liquidity risks to some extent, such as the liquidity coverage ratio. We therefore believe the 20% blanket add-on should be replaced with something more risk sensitive and properly calibrated.

We also are concerned by the lack of recognition of high quality liquid assets (HQLAs) received as margin. This means that U.S. Treasuries, which count as cash equivalents in the liquidity coverage ratio, are treated as if they were illiquid assets with no funding value. We believe the NSFR should give funding benefit for HQLAs like U.S. Treasuries.

The U.S. banking agencies released a proposed rule earlier this week. We will review this rule and update the Committee of any new developments.

Internal Models

ISDA believes capital requirements should be globally consistent, coherent and proportionate to the risk of a given activity.

As a result, we're concerned about the regulatory shift away from internal models that have been utilized under supervision by Prudential Regulators. Internal models are the cornerstone of prudent risk management, as they enable banks to identify and appropriately measure risk across various dimensions.

The move away from internal models has occurred in several areas: the recent decision by the Basel Committee to restrict the use of internal models for credit risk-weighted assets; the ditching of the advanced measurement approach for operational risk and the use of models for CVA; and the proposal to introduce capital floors, potentially on both the inputs and outputs of capital models.

Some regulators have highlighted complexity and variation in risk-weighted assets (RWAs) as a rationale for wanting to restrict the use of internal models. ISDA understands these concerns, but believes there are ways to address trepidation about RWA variability without eliminating internal models—through greater consistency and transparency of model inputs, or through ongoing benchmarking exercises that help regulators better understand the source of any differences in the way banks value their portfolios.

We need to strike the right balance between standardization and the ability of banks to maintain focus and expertise in identifying and appropriately measuring the underlying risks in their businesses.

Internal models are much more sensitive to risk and better align with how banks actually manage their business. In comparison, standardized models are relatively blunt, meaning the required capital charge for holding a particular asset might not adequately reflect its risk. This can lead to poor decision-making: a bank might

[10] Federal Reserve Chair Janet L. Yellen, Before the Committee on Financial Services, U.S. House of Representatives, Washington, D.C., November 4, 2015: *http://www.federalreserve.gov/newsevents/testimony/yellen20151104a.htm*.

choose to pull back from low-risk assets, counterparties or businesses where capital costs are relatively high. Conversely, they might opt to invest in higher-risk assets that appear attractive from a capital standpoint.

These issues were what prompted the Basel Committee to create incentives for the use of risk-sensitive internal models in the first place via Basel II. All models, standard or risk-based, have inherent weaknesses, but increasing transparency and applying benchmark testing can identify possible shortcomings. It simply isn't necessary to reverse course from Basel II and insist on an over-simplified standard model.

We believe, as a general point, that capital levels should reflect risk as closely as possible. A less risk-sensitive capital framework leads to the possibility of a misallocation of capital and an increase in systemic risk by encouraging herding behavior in the market. This raises the possibility of all market participants failing to identify emerging risks that do not necessarily exist today. Making decisions in a business that is intrinsically about taking and managing risk, based on a capital framework that is being made purposely less risk sensitive, creates its own hazards.

Along these lines, we were pleased to see the Committee recognize the value of internal models in its bill reauthorizing the Commodity Exchange Act.[11] Unfortunately, the CFTC's current approach for internal model approval in its proposed capital rule makes it impossible for entities that are not subsidiaries of U.S. bank holding companies or SEC-registered security-based swap dealers to seek CFTC model approval (see *Annex II*). This highlights the need for further dialogue between the House, Senate, the CFTC and the SEC on this subject.

Overall, a non-risk-based capital framework is also likely to lead to a rise in total capital requirements across the bank—essentially because standardized models tend to be more conservative.

Margin for Non-Cleared Derivatives

I would now like to turn to the margin rules.

As I mentioned in my introductory remarks, the implementation of margin rules for non-cleared derivatives from September will mark the completion of the last of the 2009–2011 G20 derivatives reform objectives. From that date, the largest banks will be required to exchange initial and variation margin on their non-cleared derivatives trades. All other entities covered by the rules will be subject to variation margin requirements beginning next March, with initial margin obligations phased in over a 4 year period.

ISDA has worked tirelessly for the past 3 years to prepare for implementation, and efforts have stepped up since U.S. Prudential Regulators and the CFTC published their respective final rules at the end of last year.

ISDA Standard Initial Margin Model (ISDA SIMM)

A central part of this project is the development of the ISDA SIMM, which will be available for firms to use to calculate how much initial margin needs to be exchanged. The model is now finished from a design perspective. ISDA has been touring the globe in recent months, showing the methodology to regulators, alongside a transparent governance structure, in order to smooth the path to implementation. We have shared all the data that went into the development of this model, along with the calibration, the back-testing results and independent validation confirming the model meets the requirements of a one-tailed 99% confidence interval over a 10 day horizon.

We have found the U.S. Prudential regulators,[12] the CFTC[13] and the European Supervisory Authorities' Joint Assessment Team[14] to be thoroughly engaged and knowledgeable. However, as the implementation date of September 1, 2016 draws closer, it is important that regulators move quickly to acknowledge that the ISDA SIMM is fit for service. Without the ISDA SIMM, firms are likely to utilize the fall-

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[11] H.R. 2289, the Commodity End-User Relief Act.

[12] Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation.

[13] The National Futures Association, which was recently designated by the CFTC to oversee the model application.

[14] The Joint Assessment Team was established in early 2015, with the aim to assess the compliance of the different initial margin models to the requirements of the draft joint regulatory technical standards on the European Market Infrastructure Regulation and the Basel Committee-IOSCO framework: *https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1381_-_annex_to_the_statement_by_steven_maijoor_esas_joint_committee_-_econ_hearing_14_september_2015.pdf*.

back solution of standard tables, which were developed by the Basel Committee and IOSCO as the most conservative approach and are more costly.

Phase I banks have already begun their operational builds in preparation for the September 1, 2016 implementation date. Timely approval of the model at the firm-level is critical.

Credit Support Annex—Facilitating the Flow of Margin

Another big focus has been preparing for the necessary revisions to ISDA credit support documentation in each jurisdiction. We're making very good progress here, and the first margin-compliant document was published earlier this month. ISDA is also developing a protocol to ensure the changes can be made to outstanding agreements as efficiently as possible.

There's still a lot that still needs to be done, but ISDA is working hard to deliver solutions in advance of the regulatory mandates.

There is one impediment that is standing in the way—the lack of final rules from the CFTC regarding the application of U.S. rules abroad. Without these rules, we cannot complete the legal agreements to facilitate the exchange of collateral. This is important to meet the September 1, 2016 implementation deadline.

Finalizing the Cross-Border Rules

While the margin rules were developed and agreed at a global level, the national proposals published by U.S., European and Japanese regulators initially contained a number of important differences. Variations even emerged between the proposals issued by U.S. Prudential Regulators and the CFTC.

In letters to national authorities,[15] ISDA highlighted those differences and suggested a more globally consistent approach. Ultimately, many of the biggest variations were ironed out in the final rules—but some still remain.

Let me first address the inconsistencies among international rules. Final rules from U.S. Prudential Regulators and the CFTC require variation margin to be settled the day after execution of the trade, or T+1. This approach is more or less mirrored in European rules. In comparison, Japanese proposals require variation margin to be exchanged as soon as practically possible, while Singapore and Hong Kong regulators have proposed T+2 and T+3, respectively.

These differences matter, and the tighter time frame set by U.S. and European regulators will make it practically difficult for U.S. firms to trade with Asian counterparties.

There are also differences in the treatment of non-netting jurisdictions, the scope of instrument coverage, and the scope of applicability. These variations add to the complexity of complying with the rules in multiple jurisdictions.

Turning to the U.S. rules, the CFTC's cross-border margin proposal is inconsistent with current CFTC cross-border guidance for swaps that are cleared and executed on a swap execution facility (SEF). Unlike the cross-border guidance, the CFTC cross-border margin proposal defines 'U.S. person' as entities that have a "significant nexus" to the U.S., even if they are domiciled or organized outside the U.S. It also includes a different interpretation of non-U.S. entities guaranteed by a U.S. person. This interpretation may lead to a single trade being subject to margin rules in multiple jurisdictions.

In addition, U.S. prudential rules appear to recognize that a non-cleared swaps transaction arranged by personnel or agents of non-U.S. banks located in the U.S. would be excluded from mandatory margining. However, this contrasts with the position taken in the CFTC cross-border guidance, which imposes clearing, SEF-trading and reporting requirements on trades between a non-U.S. swap dealer and a non-U.S. person if those transactions are arranged, negotiated or executed in the U.S. This requirement is currently subject to no-action relief,[16] but that relief expires in September. The CFTC should reconcile its cross-border guidance and the cross-border margin proposal with U.S. prudential rules to ensure consistency for all swaps rules.

On a positive note, we appreciate that the CFTC allows for a substituted compliance regime in its cross-border margin proposal. Under that proposal, swap dealers and major swap participants would be able to post margin under foreign rules when trading with a non-U.S. counterparty not guaranteed by a U.S. person—but that would depend on those foreign rules being deemed comparable with U.S. requirements. Market participants are concerned about the timing of these comparability determinations given the proximity of the implementation date. No determinations

[15] *http://www2.isda.org/functional-areas/wgmr-implementation/*.

[16] CFTC Letter No. 15–48: *http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-48.pdf*.

have been made so far with respect to margin rules, and the market has had no guidance on whether such determinations might be forthcoming.

Under the proposed cross-border margin rules, substituted compliance will be granted if the rules of foreign jurisdictions are consistent with the Basel Committee-IOSCO standards, which is positive. We are concerned, however, that the final rules will require an element-by-element analysis of overseas regimes.

ISDA believes that substituted compliance should be determined by whether a jurisdiction is consistent on an outcomes basis with the Basel Committee-IOSCO margin recommendation.

While U.S. Prudential Regulators included requirements for cross-border trades in their final rules, the CFTC has yet to publish its final rule. With the new regime scheduled for implementation from September, it means there's just 4 months to issue the final rule and make substituted compliance decisions. Timing is critical as ISDA is developing the legal documentation that will assist market participants in determining whether they will fall within the scope of the margin rules. Without the CFTC's final cross-border margin rule, it will be difficult for ISDA to finalize these documents by the effective date of the rules.

We urge the CFTC to publish its final cross-border margin rule as soon as possible to maximize the possibility of substituted compliance decisions before the rules of other jurisdictions become effective.

Conclusion

To sum up, banks today are significantly stronger and more resilient than they were before the crisis. Capital levels have already increased significantly. But a balance needs to be struck between making banks ever stronger by layering on additional capital and encouraging them to lend and facilitate hedging transactions.

As the Commissioner of the Japanese Financial Services Agency, Nobuchika Mori, said at ISDA's annual general meeting in Tokyo earlier this month:

> "We had better think carefully whether thick walls are enough to attain our dual goal of financial stability and growth. The Japanese heavy battleships *Yamato* and *Musashi* had the thickest walls, but we know that they were not resilient against air power. Instead of blindly trusting the thickness of the walls, we need to assess and strengthen the entire framework of prudential regulatory and supervisory policy." [17]

Global regulatory bodies have recognized this fact, and have called for further refinements to the capital framework to be made without significantly increasing capital across the banking sector.

However, ISDA studies have shown that new requirements will result in higher capital levels. How much is too much? At what point is the balance overly skewed in one direction, to the detriment of growth?

At the moment, no one knows.

ISDA believes a comprehensive impact study is necessary in order to provide regulators the information they need to make this decision. That study should cover all facets of the regulatory framework and consider the impact on all derivatives counterparties to ensure regulators are fully aware of the implications of further change.

Finally, ISDA is doing all it can to ensure the infrastructure, systems and documentation are in place to facilitate implementation of new margining requirements from September. But we remain concerned about cross-border implications. It is vital the substituted compliance framework is based on broad outcomes, rather than a line-by-line comparison of national rule-sets. We also urge the CFTC to issue its final rules as soon as possible.

I would like to close by expressing my sincere appreciation of the Committee's work and its commitment to exploring the impact of Dodd-Frank implementation through these hearings.

Thank you.

[17] Keynote address "From static regulation to dynamic supervision" by Nobuchika Mori, Commissioner, Financial Services Agency, Japan at ISDA's 31st Annual General Meeting, Tokyo, April 13, 2016: *http://www2.isda.org/attachment/ODI5OQ==/JFSA%20Speech.pdf*.

ANNEX I

derivatiViews

From the Executive Office of ISDA

FRTB: One Piece of the Capital Puzzle [18]

With any jigsaw puzzle, it takes time before the full picture starts to become visible. Look at any single piece in isolation, and the picture is unrecognizable. Slot several of the pieces into place, and the image slowly starts to take shape.

A comparison of sorts can be made with the package of capital, leverage and liquidity reforms being introduced by the Basel Committee on Banking Supervision. The Group of 20 (G20) has set out the picture it wants to end up with: a Basel III framework with an increase in the level and quality of capital banks must hold compared with the pre-crisis Basel II.

But the G20 has also decreed that any work to refine and calibrate elements of the Basel III rules prior to their finalization and implementation should be made without further significantly increasing overall capital requirements across the banking sector. (*http://www.g20.utoronto.ca/2016/160227-finance-en.html*) This is where it's hard to see how the pieces come together.

The latest segment of the capital jigsaw to be slotted into place is the Fundamental Review of the Trading Book (FRTB), an initiative to overhaul market risk requirements. In its January publication of the final FRTB framework, the Basel Committee estimated the revised standard would result in a weighted mean increase of approximately 40% in total market risk capital requirements. That estimate, though, was based on a recalibration of quantitative-impact-study data from an earlier version of the rules.

As a result, *ISDA decided to lead an additional industry study [2]* (*http://www2.isda.org/attachment/ODM0OA==/QIS4 2015 FRTB Refresh Report_Spotlight__FINAL.pdf*) based on data from 21 banks to determine the impact of the final requirements—and the results were unveiled at ISDA's 31st annual general meeting in Tokyo last week.

The study shows an overall increase in market risk capital of between 1.5 and 2.4 times compared to current market risk capital. The lowest estimate of 1.5 times assumes all banks will receive internal model approval for all desks. If all banks fail the internal model tests for all trading desks, market risk capital would increase by 2.4 times. ISDA believes the end result will be somewhere in between, but this will depend on two key variables: interpretation of rules on a so-called P&L attribution test and whether the calibration of capital floors applies to market risk.

The former is particularly important—and currently problematic. Under the FRTB, banks have to apply for regulatory approval to use internal models for each trading desk, with approval dependent on passing a P&L attribution test (essentially comparing internal capital systems with front-office models). But there is currently a lack of clarity over how this test will work in practice, while banks have not had time to develop the infrastructure that would enable them to produce the data required for the test.

Without more certainty on the methodology, and without knowing whether or at what level capital floors will be set, it is difficult to accurately estimate the ultimate impact. But it is unlikely all banks will receive internal model approval for all desks, meaning the end result may be closer to 2.4 times than 1.5 times.

Crucially, the study shows the final FRTB framework hasn't eliminated a cliff effect between standardized and internal models. If a particular desk loses model approval, capital requirements could immediately increase by multiple times. This had been something the Basel Committee had wanted to eliminate.

The FX and equity markets are most affected. Losing internal model approval under the new rules would result in a 6.2 times increase in capital for FX desks and a 4.1 times increase for equity desks.[19]

These are big increases, and come on top of the jump in capital requirements already envisaged in Basel III. The question is whether this single piece of the jigsaw suggests the final picture will be out of line with what the G20 expects. To put it more simply, will this piece, when combined with other changes in the capital framework, ultimately result in further significant increases in capital across the banking sector? The honest answer is that no one knows.

[18] *ISDA derivatiViews,* April 21, 2016: *https://isda.derivativiews.org/2016/04/21/frtb-one-piece-of-the-capital-puzzle/*.

[19] These numbers exclude the so-called residual risk add-on, non-modellable risk factors and diversification across risk classes under internal models.

We do, however, know that large increases in capital could mean certain business lines end up becoming uneconomic. This could severely affect the ability of banks to provide risk management services and reduce the availability of financing for borrowers. At a time when some jurisdictions are increasingly focused on initiatives to generate and sustain economic growth, that's a concern.

Summary of the Industry Study on the Final FRTB Rules [20]

FRTB QIS4 Refresh—Spotlight

- ➢ **Significant step in right direction—Highlights:**
  - ➤ SA methodology overall capital charge is 2.4× compared to current market risk capital (QIS4: 4.2×); and
  - ➤ Residual risk add on in standard rules has reduced to 6% (QIS4: 49%) of total SA capital.
- ➢ NMRF remains a big component of internal models approach capital charge 30% (QIS4: 29%)
- ➢ **Cliff effect between standard rules and internal models remains because:**
  - ➤ Banks were asked to assume most desks obtain model approvals in the QIS instructions. In reality most banks are likely to lose model approval for a number of desks due to stringent tests;
  - ➤ Capital floors based on some percentage of standardized approach will be imposed; and
  - ➤ Cliff effect between the IMA and SA varies materially between and within risk classes, which may result in significant reallocation of capital and business activity.

	SA to IMA *
Interest rate risk	3.0
Credit spread risk	2.0
Equity risk	4.1
Commodity risk	2.9
Foreign exchange risk	6.2

* SA excluding residual risk add on & IMA excluding NMRF.
* Results based on data contributed by 21 banks, refreshing earlier QIS4 analysis based on final FRTB rules.

- ➢ **Charges on securitization products improved in the final text, however, when looking at capital for the securitization portfolio including hedges, we see a significant increase in capital** *versus* current levels.
- ➢ **The results of P&L Attribution test and the calibration of the capital floor based on standard rules need to be considered to assess the full capital impact and how the change will translate to bank business models.**

ISDA gfma IIF

ANNEX II

Under the CFTC's proposed capital rule, non-bank swap dealers that are subsidiaries of an entity with capital models approved by the Federal Reserve or SEC can seek CFTC approval of such internal models to calculate their related CFTC capital requirements.

Unfortunately, this approach leaves some ISDA members with no ability to seek CFTC model approval to calculate regulatory capital requirements. Specifically,

[20] *http://www2.isda.org/attachment/ODM0OA==/QIS4%202015%20%20FRTB%20Refresh %20Report_Spotlight__FINAL.pdf*

those members that are neither a subsidiary of a U.S. bank holding company nor an SEC-registered security-based swap dealer will be unable to seek CFTC model approval. This holds true for swap dealers that are subsidiaries of non-U.S. financial institutions subject to robust home-country prudential regulation in a jurisdiction that is a member of the G20 or a member of the Basel Committee.

Without an approved model, a swap dealer will be required to use a rigid standardized approach to calculate capital and margin requirements. The significantly higher costs associated with the standardized approach would make continued swap activity severely cost-prohibitive. The significant cost increase will result in higher costs for end-users and create an unlevel playing field among dealers engaged in the same business, in the same markets, with the same customers. We do not believe that an aim of the Dodd-Frank Act was to cause significantly higher costs for end-users, or for regulators to pick winners and losers among swap dealers and major swap participants. Nonetheless, these are the likely outcomes if model approval is unduly restricted.

We understand there has been a productive dialogue between the CFTC, SEC and market participants on these issues and we encourage it to continue. ISDA also appreciates that the House and Senate CFTC reauthorization bills provide for consultation between regulators on models, and authorize non-bank swap dealers to use comparable models to the extent bank swap dealers use an approved model.

The CHAIRMAN. Mr. Deas.

STATEMENT OF THOMAS C. DEAS, JR., REPRESENTATIVE, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE; REPRESENTATIVE, COALITION FOR DERIVATIVES END-USERS, WASHINGTON, D.C.

Mr. DEAS. Good morning, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee.

I am Tom Deas, testifying on behalf of the U.S. Chamber's Center for Capital Markets Competitiveness and the Coalition for Derivatives End-Users. I am also Chairman of the National Association of Corporate Treasurers.

The Chamber and the Coalition for Derivative End-Users, along with NACT, represent hundreds of companies across the country that employ derivatives to manage risk in our day-to-day business activities.

First, let me sincerely thank, both the Chairman, the Ranking Member, and the Members of this Committee for doing so much to protect derivative end-users from the burdens of unnecessary regulation. When it comes to main street businesses, the Members of this Committee have worked together to get things done. Last year, you led the charge in enacting both the end-user margin bill and the centralized treasury unit bill, directly benefitting the end-user community. We sincerely appreciate these efforts.

Congress did this because they recognized that end-users do not engage in the kind of risky, speculative derivatives activity that became evident during the financial crisis. End-users comprise less than ten percent of the derivatives markets, and we use derivatives to hedge the risks in our day-to-day business activity. We are offsetting risks, not creating new ones.

We support the Dodd-Frank Act's goal of increasing transparency in, and reducing systemic risks of, the derivatives markets. However, at this point, almost 6 years after passage of the Act, there are still areas where the continuing uncertainty compels end-users to appeal for legislative and regulatory relief. End-users are also seeing the cumulative impacts of the elaborate web of new rules and regulations, including those placed on our counterparties; that is, rules that require our counterparties to meet certain tests regarding capital, liquidity, and margin, are leading to significant realized and potential impacts on end-users. Despite being exempted from the capital and margin requirements, end-users still face the distinct possibility that our hedging activities will become too costly because of the new and higher capital requirements, margin and liquidity requirements, imposed on our counterparties.

For example, under the net stable funding ratio, long-term funding costs will discourage dealer involvement in derivatives, thereby reducing available counterparties and liquidity for end-users. We understand the banking regulators have proposed their net stable funding ratio rule this week, and we are in the process of reviewing it and its impacts on end-users.

Another example is the supplemental leverage ratio, which does not permit the clearing member to receive credit for the segregated initial margin posted by its end-user customers. The failure of the SLR to recognize the risk-reducing effect of segregated client collateral will likely lead to fewer banks willing to provide clearing services for customers, and will likely increase costs to end-users generally.

Differences in the credit valuation adjustment risk capital charge between the United States and other jurisdictions, such as Europe, also create competitive disadvantages. Europe provides an exemption that avoids the CVA charge being factored onto the pricing, and passed on to end-users, however, in the United States no such exemption exists, leading to the potential for large pricing differences when trading with U.S. compared to EU banks.

Many end-users engage in derivatives with both non-bank, as well as bank swap dealers, and we are concerned about the impact on liquidity of certain restrictions on models for non-bank swap dealers, which would not permit the use of internal models for computing market risks, and counterparty credit charges for capital purposes. This approach requires non-bank swap dealers to hold significantly more regulatory capital, which ultimately will force them potentially to exit the business, leaving end-users with fewer choices for access to risk mitigation tools.

To summarize, end-users are concerned about the apparent disparity between an exemption from clearing and margin requirements on the one hand, and the pass-through costs resulting from new capital and liquidity rules imposed on their counterparties. We also fear that cross-border regulatory uncertainty and conflict could put American companies at an economic disadvantage. Although these capital and liquidity rules do not create affirmative requirements directly on end-users, they, nevertheless, create real impacts and costs. The imposition of unnecessary burdens on end-users restricts job growth, decreases investment, and undermines our competitiveness around the globe, leading to material cumulative impacts on corporate end-users and our economy.

Thank you again for your attention to the needs of end-user companies.

[The prepared statement of Mr. Deas follows:]

PREPARED STATEMENT OF THOMAS C. DEAS, JR., REPRESENTATIVE, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE; REPRESENTATIVE, COALITION FOR DERIVATIVES END-USERS, WASHINGTON, D.C.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross section of the American business community with respect to the number of employees, major classifications of American business—*e.g.,* manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

The Coalition for Derivatives End-Users represents the views of end-user companies that employ derivatives to manage risks. Hundreds of companies and business associations have been active in the Coalition on both legislative and regulatory matters and our message is straightforward: financial regulatory measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users, who are the engines of the economy. Imposing unnecessary regulation on derivatives end-users, parties that did not contribute to the financial crisis, would fuel economic instability, restrict job growth, decrease productive investment and hamper U.S. competitiveness in the global economy.

Mr. Chairman, Ranking Member Scott, other Members of the Subcommittee, thank you for inviting me to testify at this important hearing, which focuses on matters of significant concern to the end-user community. I am Thomas C. Deas, Jr., Chairman of the National Association of Corporate Treasurers, an organization of treasury professionals from several hundred of the largest public and private companies in the country. I am testifying today on behalf of both the U.S. Chamber of Commerce ("Chamber") and the Coalition for Derivatives End-Users ("Coalition"). The Chamber is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions. The Coalition includes more than 300 end-user companies and trade associations, including the National Association of Corporate Treasurers. Collectively, the Chamber and the Coalition represent a wide and diverse population of domestic and international commercial businesses and trade associations.

As detailed below, we strongly believe that there are many capital and liquidity requirements impacting our counterparties that will directly impede the ability of end-users to effectively manage risks and result in higher costs for the end-user community, and ultimately consumers. Specifically, these include:

- The Net Stable Funding Ratio;
- The Supplemental Leverage Ratio;
- Restrictions on Models for Non-Bank Swap Dealers;
- Competitive Issues Surrounding the Credit Valuation Adjustment;
- The Swap Dealer *De Minimis* Threshold; and
- The Cumulative Impact of Capital Rulemakings on End-Users

Background

The Chamber's mission is to ensure America's global leadership in capital formation by supporting robust capital markets that are the most fair, transparent, efficient, and innovative in the world. As part of that mission, the Chamber recognizes the acute need for commercial end-users to effectively manage risk. Similarly, the Coalition, representing the engines of our domestic and global economy, has consistently supported financial regulatory measures that promote economic stability and transparency without imposing undue burdens on derivatives end-users.

At the outset, let me thank the Members of this Subcommittee and the full Committee for their bipartisan efforts and focus on ensuring that Main Street businesses have the tools and access to capital necessary to operate and grow. Last year, you led the charge in enacting key legislation to protect end-users, including the end-user margin bill, which clarified that end-users are not subject to margin requirements for their uncleared swaps, and the centralized treasury unit bill, which helped ensure that end-users can continue to use a risk-reducing best practice. Similarly, the Commodity End-User Relief Act includes several provisions that will provide immediate relief to end-users who rely on risk management tools to keep their operations and businesses running during times of uncertain volatility.

Despite these laudable efforts, however, end-users still face the distinct possibility that their hedging activities will become too costly because of new and higher capital, margin and liquidity requirements imposed on their bank and non-bank counterparties. In essence, this means that the significant progress Congress has made to ensure that end-users do not bear the brunt of costs associated with derivatives risk management, including exemptions from clearing and margin requirements, are pyrrhic victories. In particular, I wish to highlight the impact of the following capital and liquidity requirements, which have resulted either in higher costs for end-users (or will do so once fully implemented) or will incentivize end-user counterparties to leave the market altogether.

Net Stable Funding Ratio

The Chamber and the Coalition believe that the Basel Committee of Banking Supervision's net stable funding ratio ("NSFR") which would lead to billions in additional funding requirements for derivatives activities, does not take into account the impacts on end-users. This is especially concerning given that many of the provisions of the NSFR would further restrict end-users' ability to hedge by increasing the cost of risk management and could lead to decreased liquidity in the derivatives markets. We understand that the Prudential Banking Regulators released their proposed rules on the NSFR earlier this week and we will be carefully reviewing their proposals and evaluating the impact on end-users.

In particular, the concern is two-fold: (1) long-term funding costs required under the NSFR limit and discourage dealer involvement in derivatives and derivatives-related transactions, effectively reducing liquidity in the market that end-users rely on to hedge risk; and (2) costs associated with capital-raising in a less liquid market would inevitably be borne by derivatives end-users and consumers. The immediate impact of the NSFR can already be seen as fewer bank counterparties are willing to extend longer-term credit, including in the form of swaps used to hedge long-term exposures. Additionally, the costs to hedge are likely to be passed on to end-user companies in the form of increased fees or transaction costs, less favorable terms, and collateral requirements.[1]

These concerns are particularly reflected in the add-on costs associated with counterparty payables; the treatment of uncollateralized receivables; the lack of collateral offsetting provisions; and the liquidity squeeze related to the treatment of corporate debt. For example, requiring dealer counterparties to provide required stable funding for 20% of the negative replacement cost of derivative liabilities (before deducting variation margin posted) is a clear example of the direct burdens that would affect end-users' ability to efficiently mitigate risk.

Another concern under the NSFR is the treatment of dealers with respect to uncollateralized net receivables, which could require 100% long-term funding. As we are now seeing, end-users are being required to collateralize transactions with cash margin to meet the stringent Basel III leverage ratio requirements. Or, if a dealer counterparty did not demand collateral, the costs of long-term funding could simply be passed on to end-users through embedded derivatives fees.

Moreover, we believe that disproportionate discounting of collateral posted forces dealers to mitigate costs elsewhere. As a result, in implementing the NSFR, the Prudential Banking Regulators should align collateral posted by commercial end-users with long-term funding obligations under NSFR. This is particularly true because, while most end-users are exempted from posting margin for their derivatives with bank counterparties, the "back to back" hedges entered into by banks to offset end-user transactions are still subject to mandatory clearing and margin require-

[1] A January 2015 study of the OTC derivatives market by Oliver Wyman concluded that the NSFR's treatment of OTC derivatives would require an additional $500 billion in long-term funding, generating $5–$8 billion in incremental costs to the industry, with a cost increase of 10–15% for derivatives transactions.

ments. Consequently, the costs borne by banks to offset end-user transactions are passed on to the very end-users that were meant to be exempt from the costs of mandatory clearing and margin requirements—and ultimately to consumers.

Further, the NSFR's treatment of corporate debt could hinder end-user capital raising efforts. The NSFR does not take into account the maturity of end-user-issued debt when determining a dealer's required stable funding and would restrict liquidity in the corporate debt markets by requiring dealers to raise 50–85% long-term funding to support their inventory, which would discourage market making. End-users rely on market-based funding and the importance of liquid markets for corporate bonds and commercial paper ("CP"). To cite a real-world example of the costs and diminished liquidity from these rules, many corporate treasuries issue CP daily to balance their funding requirements. If they are faced with a same-day payment that they identify too late in the day to complete a placement in the market of the required CP, their bank CP dealer frequently will take the paper overnight for its own account and fund-out the requirement the next day. The NSFR rules require the bank to hold 85% of that overnight funding as long-term funding—at a cost over ten times the overnight amount. Ultimately this liquidity will no longer be available to end-user treasury departments. Accordingly, the Prudential Banking Regulators should carefully consider the impact of the NSFR's 50–85% long-term funding requirements on end-users.

Supplemental Leverage Ratio

The supplemental leverage ratio ("SLR") penalizes high quality assets and acts as a disincentive to market participants to provide clearing services. The SLR does not permit the clearing member to take "credit" for the segregated initial margin posted by its customer that is expressly for the purpose of limiting the clearing member's exposure to derivatives. Further, segregated initial margin in the form of cash may be required to be added to a clearing member's balance sheet exposure, requiring additional capital. The overall result of the SLR seems to ignore the fact that for derivatives cleared on behalf of a customer, the customer's segregated initial margin must be held to margin the customer's positions and cannot be used as leverage by the clearing firm.

Ultimately, the failure of the SLR to recognize the risk-reducing effect of segregated client collateral will likely lead to fewer banks willing to provide clearing services for customers, thus constraining the ability of end-users that clear derivatives to access central clearing. Further, even end-users that do not clear their derivatives will likely see the impact of the SLR in the form of increased costs for hedging, as their bank counterparties will see their clearing costs increase on their back to back hedges and will pass those costs along to end-users. We are hopeful that regulators can work together to get this right in the United States and abroad.

Restrictions on Models for Non-Bank Swap Dealers

Another significant issue directly impacts non-bank swap dealers, many of which routinely do business with end-users. As proposed in 2011, the CFTC's capital rules for non-bank swap dealers do not permit the use of internal models for computing market risk and counterparty credit risk charges for capital purposes. Instead, they must use the "standardized approach," which measures market risk according to standards established by the Basel Committee on Banking Supervision, generally requiring capital for both "general" and "specific" risks.

These two approaches differ significantly, particularly with respect to dealing in commodity derivatives. For many asset classes, non-bank swap dealers using the standardized approach would be required to hold regulatory capital potentially hundreds of times more than swap dealers using the internal models approach. This regulatory disparity will ultimately force those dealers to exit the business, leaving end-users with fewer choices for access to risk mitigation tools. Moreover, the disparity creates an unlevel playing field between bank and non-bank dealers participating in the same markets, ultimately resulting in higher costs for end-users.

In this respect, Section 311 of the Commodity End-Users Relief Act would permit the use of comparable financial models by non-bank swap dealers and major swap participants. This provision would help ensure comparability in capital requirements across all swap dealers (whether bank or non-bank) and eliminate a commercial disparity that only raises costs on end-users that decide to do business with non-bank swap dealers.

Competitive Issues Surrounding the Credit Valuation Adjustment

European policymakers have implemented capital charges on derivatives positions significantly more favorable to end-users than the U.S. Prudential Banking Regulators. The European approach recognizes that end-users' hedging activities are in fact reducing risks, and accordingly, exempts end-user derivatives transactions from the credit valuation adjustment ("CVA") risk capital charge, which would otherwise require the calculation and subsequent holding of capital to mitigate counterparty credit risk in a derivatives transaction. The absence of a U.S. exemption puts American companies at a meaningful competitive disadvantage compared to our European competitors.

In particular, we note that lack of a CVA exemption forces end-users to enter into credit support enhancement agreements that a bank would normally not deem necessary in the absence of regulation. If banks require collateral, end-users may be put in the position of borrowing from financial institutions to finance the margining associated with those transactions, resulting merely in a shift of risk between financial institutions. This result contradicts the objective of facilitating end-user access to capital, drives costs directly to end-users, and does nothing to mitigate risk within the financial system, as the risk is simply being transferred from one bank to another.

Swap Dealer *De Minimis* Threshold

Finally, we believe that the CFTC should follow clear Congressional intent and promptly draft an interim final rule that makes clear that the swap dealer *de minimis* exception threshold shall remain at the $8 billion gross notional level or be raised. The Chamber and Coalition are concerned that any decrease below the current $8 billion level could reduce liquidity and the availability of counterparties for end-users to trade with, thereby concentrating risk in fewer counterparties and negatively impacting end-users' ability to hedge.

Indeed, we believe that the swap dealer *de minimis* exception should remain broad enough to exclude swap dealing activities that do not rise to the level of systemic significance, either because the level of activity or the type of transaction. Lowering the threshold from the $8 billion gross notional amount would needlessly and unnecessarily capture a significant number of additional market participants and require them to register as swap dealers or, more likely, reduce their available products and services to derivatives end-users to ensure they remain below the thresholds.

Any decrease from the current threshold would likely cause a further consolidation of swap dealing activities, reducing competitiveness and potentially increasing risk. Such changes to the market would reduce liquidity to end-users, reduce counterparty selection and increase interconnectedness of counterparties—results that run contrary to the goals of the Dodd-Frank Act.

In this respect, we fully support Section 310 of the Commodity End-Users Relief Act, which would set the *de minimis* threshold of swap dealing at $8 billion. This section would ensure that the *de minimis* threshold could only be amended or changed through a new affirmative rulemaking by the CFTC.

Cumulative Impact of Capital Rulemakings on End-Users

In summary, we believe the legislative intent of the Dodd-Frank Act was to exempt end-users from having to use their own capital for mandatory margining of derivatives transactions, diverting these funds from investment in business expansion and ultimately costing jobs. The imposition of additional capital requirements by U.S. Prudential Banking Regulators would undermine this intent by forcing our bank counterparties to hold much more of their own capital in reserve against end-users' derivatives positions, passing on the increased costs to these end-users.

The larger point, which I know this Subcommittee appreciates, is that the cumulative effect of new derivatives regulation threatens to impose undue burdens on end-users. The indirect but potentially even more onerous regulation of end-users through bank capital and liquidity requirements serves to discourage end-user risk management through hedging and would effectively negate the benefits of Congress's clear intent to exempt end-users from margin requirements. The importance of smart prudential regulation that promotes Main Street business has been echoed by Members of Congress, including by Chairman Conaway, who has noted that bipartisan efforts must "protect end-users from being roped into reporting, registration, or regulatory requirements that are inappropriate for the level of risk they can impose on financial markets. It is clear that end-users did not cause the financial crisis, they do not pose a systemic risk to the U.S. financial markets, and they should not be treated like financial entities." [2]

We need a regulatory system that allows Main Street to effectively use derivatives to hedge commercial risk, resulting in key economic benefits; one that allows busi-

[2] Press Release, *Congressman Conaway Praises Approval of the Customer Protection and End User Relief Act,* U.S. Representative Mike Conaway (Apr. 9, 2014), available at *http://agriculture.house.gov/news/documentsingle.aspx?DocumentID=1110*.

nesses—from manufacturing to healthcare to agriculture to energy to technology—to improve their planning and forecasting, manage unforeseen and uncontrollable events, offer more stable prices to consumers and contribute to economic growth. End-users are entering into derivatives to mitigate the business risks they face in their day-to-day business activities. In this respect they are fundamentally different from swap dealers who maintain an open book of exposures against which posting of cash margin is not unwarranted. However, when rules intended to apply to swap dealers directly or indirectly burden end-users, it is the end-user segment of our economy that bears the higher costs. The imposition of unnecessary burdens on end-user businesses restricts job growth, decreases investment and undermines our competitiveness in Europe and elsewhere across the globe—leading to material cumulative impacts on corporate end-users and our economy.

Thank you and I am happy to address any questions that you may have.

The CHAIRMAN. Mr. Gellasch.

STATEMENT OF TYLER GELLASCH, FOUNDER, MYRTLE MAKENA, LLC, HOMESTEAD, PA

Mr. GELLASCH. Chairman Scott, Ranking Member Scott, Chairman Conaway, and other Members of the Committee, thank you for inviting me here today.

The testimony I am going to give today represents my views, and not those of the trade association or others members.

And I agree with your remarks. I actually believe that we can have more resilient markets and still protect end-users. And I also want to start today by recognizing the obvious; that inadequate regulation of derivatives turned the mortgage crisis into a worldwide financial meltdown. And in response to that crisis, regulators around the world designed rules to make our markets more fair, more transparent, more stable, and less likely to cause the next financial crisis.

I think it is clear they have actually done that. But unlike some of my colleagues here today, I want to share with you that these important reforms are not actually having a profound negative impact on real end-users. And the elaborate web of rules, that my colleagues referenced a moment ago, don't actually apply to them, and in part because of your hard work, but in part because of smart choices also made by our regulators.

Today's topic focuses largely on margin and capital, and I think that is actually the most important part of the crisis. The largest firms, AIG and the banks, had hundreds of billions of dollars on their balance sheets, and yet they still were not able to weather the storm, in large part because they had inadequate margin from their counterparties, and they had inadequate capital to absorb the losses, so the taxpayers did.

And I want to explore for a moment exactly what margin and capital are. As Mr. Lukken said, margin is the first line of defense for a counterparty. It is an asset often extremely liquid in securities that are used to satisfy the obligation. And it has been a hallmark of our capital markets for decades around the world, and it is actually the only reason to promote liquidity in times of financial stress. Capital, by contrast, ensures that the firm has enough of its own, not borrowed, money to meet the foreseeable obligations; essentially, to stay solvent. If margin is the first line of defense for a counterparty in the time of a crisis, then capital and leverage limits are the last before the bailout.

Once the crisis hit, everyone realized that we needed more margin and capital in the system, and the G20 summits focused squarely on those issues. And that is actually what Dodd-Frank did as well. And now we are hearing from many of the largest banks and financial firms and their trade groups here, that the requirements on them will have, and I will again use their words, profound negative impacts, or impede the ability of end-users to manage their risks. And I am here to say I respectfully disagree, and the reason is, frankly, simple math. And let me use an example from real life that I am familiar with, and it is a real commercial end-user, it was a parts supplier in Michigan who has a $100,000 loan with an interest rate risk associated with that, and they want to engage in perhaps a swap to fix that risk. So now they go to a bank with a 7½ percent capital requirement. Okay. So the real risk for them may be just $1,000, the actual full risk. So the market value is $1,000. The capital for that is about $75, 7½ percent of that. But we are not even talking about the $75 on this $100,000 swap. We are talking about the difference between that being borrowed money and that being the financial firm's own money.

So what is the difference there? That is actually about $7½. So what we are really talking about on a $100,000 swap is an incremental cost to the bank or to the large financial firm of basically a ham sandwich downstairs. That is the amount of money we are actually talking about. That is the profound impact of the cost that we are worried about being passed on to the end-users.

Again, the end-user itself isn't posting any margin. It is not posting any capital. It doesn't have to keep those things. And those folks were appropriately exempted from the regulation.

So one thing I want to take a few moments to talk about is who are the financial firms. Obviously, we have the largest banks who are familiar with capital and margin requirements that have applied to them for decades, but we also have the largest financial services firms. We have the insurance companies, we have the hedge funds, mutual funds, the futures commission merchants, we have those folks. I would argue that actually that bucket is precisely the bucket that these rules are designed to target, and the reason is AIG, Long-Term Capital Management, MF Global, those are the firms that we actually do have to worry about. And for them, margin and capital rules, some of them may apply, and some of them are not very familiar with it, and I recognize that.

And then, of course, we have the real end-users, the farmers cooperatives, the manufacturers, they had nothing to do with this crisis, and no one agrees that they did. What is interesting is we are doing our best now, and with your Committee's great work, making sure that these rules don't apply to them.

The last point I want to make is something that my colleagues also referenced with respect to the cross-border issues. I share the concerns with both mutual recognition and making sure that our regulators work collaboratively around the globe.

With respect to whether or not we exempt, or our regulators cede jurisdiction to others, I would say be very careful. It was, in fact, the London trading desks of some of the largest firms that led to some of the large losses, so I would urge them to be careful.

Again, thank you for inviting me here today, and I look forward to any questions.

[The prepared statement of Mr. Gellasch follows:]

PREPARED STATEMENT OF TYLER GELLASCH, FOUNDER, MYRTLE MAKENA, LLC, HOMESTEAD, PA

Chairman Conaway, Ranking Member Peterson, Chairman Scott, Ranking Member Scott, and other Members of the Committee, thank you for inviting me here today.

Effective derivatives regulation is an incredibly important topic for our economy, and one in which I have deep interest. A little more than 7 years ago, I left private law practice and joined the Senate staff at a time when our country was facing the worst financial crisis in generations. As counsel to a senior United States Senator who also chaired the Senate Permanent Subcommittee on Investigations, I had the privilege of assisting the Senator with investigating the causes of the crisis and crafting legislation designed to prevent future crises. Later, I had the privilege of helping regulators carefully implement that legislation as intended.

I now run a small consulting firm, Myrtle Makena, and also serve as Executive Director of the Healthy Markets Association, an investor-focused nonprofit coalition focused on equity market structure issues. The testimony I give today represents my own views, and not necessarily those of my association or its members.

The Financial Crisis

This Committee is continuing a conversation that began in earnest as the world was coming to grips with the worldwide financial meltdown. Beginning in the fall of 2008, over the course of just a few months, U.S. regulators began pouring several trillion dollars into the financial markets to help prop up and save some of the largest financial firms.[1] Many people remember the $700 billion Troubled Asset Relief Program (TARP), which pumped tens of billions of dollars into AIG, Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, Wells Fargo, and others.[2]

But why did AIG[3] and the banks need rescuing in the first place? What went wrong? How could these enormous firms, with hundreds of billions of dollars on their balance sheets—and billions more off their balance sheets—suddenly teeter on the brink of collapse? The answer is why we're here: margin and capital. Or more importantly, it was the lack of them.

It is worth recalling how that happened. Beginning in the 1990s, the swaps market grew rapidly as a remarkably efficient way to transfer risk between parties.[4] And while many people appreciate that a mortgage crisis precipitated the financial crisis, what most people don't know (or at least didn't until *The Big Short*) was how bad mortgages on Main Street actually helped cause a financial crisis on Wall Street. That happened through big bets, particularly in swaps, and lack of margin and capital to back up those bets.[5]

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[1] The U.S. Government and regulators used more than a dozen new and previously existing programs (and more than 21,000 transactions) to provide trillions of dollars in assistance to U.S. and foreign financial institutions to promote liquidity and prevent a financial collapse. That's on top of the FDIC and Treasury Department extending guarantees to trillions of dollars in assets for a range of institutions and markets. *See, e.g.,* Press Release, *Department of the Treasury, Treasury Announces Temporary Guarantee Program for Money Market Funds* (Sept. 29, 2OO8), available at *http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx;* see also, *Temporary Liquidity Guarantee Program: Fourth Quarter 2010,* FDIC.

[2] See, *https://www.treasury.gov/initiatives/financial-stability/reports/Pages/TARP-Housing-Transaction-Reports.aspx*.

[3] Other non-bank financial firms also suffered enormous losses. Some were bailed out (directly or indirectly), while others were not. For example, Lehman Brothers Holdings Inc., with more than 209 registered subsidiaries spanning 21 countries, was not bailed out, leaving courts around the world wrestling with how to apply more than 80 different jurisdictions' insolvency laws to untangle more than 900,000 outstanding derivatives contracts. Michael J. Fleming and Asani Sarkar, *The Failure Resolution of Lehman Brothers,* Federal Reserve Bank of New York Economic Policy Review (Dec. 2014), available at *https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf*.

[4] These efforts were aided by increased financial engineering, standardization of terms and basic contracts (such as the development of the ISDA Master Agreement, Credit Support Annex, and CDS Model), and deregulation. See also Futures Trading Practices Act of 1992 and the Commodity Futures Modernization Act of 2000.

[5] For example, suppose I borrow $10 from Lending Corp and promise to pay it back $11 next year. Lending Corp might be worried that I won't pay it back. So Lending Corp could buy insur-

Continued

The Senate Permanent Subcommittee on Investigations conducted a years-long bipartisan investigation into figuring out how bad mortgages turned into a global financial crisis, and wrote up its findings in a comprehensive staff report.[6] So too did the Financial Crisis Inquiry Commission.[7] Other Congressional committees, prosecutors and regulators also researched the issues. They all found that financial firms had created financial instruments linked to mortgages that increased the level of risk and leverage to financial firms—in particular, because of inadequate margin and capital.

Because these financial instruments were traded with so little margin and the firms had so little capital, once any doubt was raised about the ability of the other side to pay up, it immediately imperiled the liquidity—and quickly, the solvency—of the entire system.

In many ways, what the government did in 2008 and early 2009 was funnel money to all of the major financial firms so they could make good on their bets. For AIG, this meant that taxpayers effectively gave AIG enough money to post margin and pay its bets,[8] while also buying out some of the bets directly.[9] Thus, AIG's collapse may be thought of as a poster child for what happens when there are inadequate counterparty credit protections—again, margin and capital.[10]

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ance, called a credit default swap, from Swap Corp. This swap may cost Lending Corp 25¢. Swap Corp collects 25¢ today, and if I don't pay back Lending Corp in 1 year, Swap Corp pays Lending Corp $11. Either way, Lending Corp should make a 7.5% return on its loan to me ($11–$0.25). That seems reasonable enough.

Now suppose ten other firms all buy the same "insurance", even if they don't have any interest in my repaying Lending Corp? They're just speculating on me repaying Lending Corp. Each time, Swap Corp will dutifully collect their 25¢, giving it $2.25.

If I repay Lending Corp, Lending Corp gets its $11, and Swap Corp will keep its $2.25 in payments. But what if I don't repay Lending Corp? Swap Corp will suddenly owe $110. Unless Swap Corp has significant backup capital, Swap Corp may not have enough money to pay up. After all, it only took in $2.25. And what about Lending Corp and the other ten firms, who may now be relying on that $110 to pay their bills? There's the potential for chaos.

Swap out the name Swap Corp from my example and call it AIG. In the run up to the crisis, AIG sold this type of default insurance on billions of dollars of mortgage-related products. It dutifully collected the quarters, but when it came time to pay up the dollars, it didn't have the money.

This highly stylized example is also overly conservative. In many instances, the party selling protection (*e.g.,* AIG), charged significantly less than the 2.5% suggested above. This premium was often sold as basis points, often settling well-below 1%. The rapid rise in perceived risk of default may often lead to a rapid rise in CDS premium rates. Still, the overall rates were below what one might suggest. For example, during the Greek debt crisis days of 2010, 5 year CDS on Greek sovereign debt jumped to a little over 4%. The impacts of these changes, however, are often dramatic on the borrower, as the increased CDS prices are often priced into the sales of new debt.

[6] *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse,* Homeland Security and Government Affairs, Permanent Subcommittee on Investigations, Majority and Minority Staff Report, (Apr. 13, 2011) ("Senate Financial Crisis Report").

[7] *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States,* Financial Crisis Inquiry Commission, (2011), available at *https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.*

[8] Press Release, *AIG Discloses Counterparties to CDS, GIA, and Securities Lending Transactions,* American International Group, Inc., March 15, 2009, ("AIG Press Release"), *Attachment A.* For example, after receiving billions in TARP funds in September 2008, AIG used a whopping $52 billion to support trading done by its London-based Financial Products group. Of that, it funneled $22.4 billion to its counterparties as collateral for CDS trades and another $12.1 billion paying back municipalities. That doesn't count the $43.7 billion used to pay back firms (largely banks) with securities lending deals, nor the $29.6 billion a Federal Reserve-sponsored financing unit, Maiden Lane III, used to pay AIG and its counterparties for its CDS contracts. AIG Press Release. For just the CDS collateral bets, AIG paid out as CDS collateral $4.1 billion to Société Générale, $2.6 billion to Deutsche Bank, $2.5 billion to Goldman Sachs, and $1.8 billion to Merrill Lynch. AIG Press Release, *Attachment A.*

[9] *See, e.g.,* AIG Press Release, *Attachment B* (reflecting payments of $6.9 billion to Société Générale, $5.6 billion to Goldman Sachs, $3.1 billion to Merrill Lynch, and $2.8 billion to Deutsche Bank).

[10] As Senator Chris Dodd stated in early 2010, "But what was once a way for companies to hedge against sudden price shocks has become a profit center in and of itself, and it can be a dangerous one as well, when dealers and other large market participants don't hold enough capital to back up their risky best and regulators don't have information about where the risks lie. AIG was a classic example, of course, where that happened." 156 *Cong. Rec.* S5828–01 (July 14, 2010) (statement of Hon. Chris Dodd, U.S. Senator). Interestingly, AIG was warned before the collapse that its bets were bad. The model for Ryan Gosling's character from *The Big Short,* Greg Lippmann, told Senate investigators that he spent hundreds of hours trying to convince AIG to stop buying RMBS and CDOs, and stop selling single name credit default swaps (CDS) on those securities. Senate Financial Crisis Report, at 343.

Regulatory Response to Financial Crisis—Increasing Margin and Capital for Derivatives Trading

Almost immediately, governments around the world recognized that swaps and those who trade a significant amount of them needed to be better regulated. In September 2009, the G20 Summit in Pittsburgh reflected a commitment by world leaders to strengthen the international financial regulatory system by, amongst other things:

- Building high quality capital and mitigating pro-cyclicality;
- Improving over-the-counter derivatives markets, including by requiring "non-centrally cleared contracts . . . to higher capital requirements"; and
- Addressing cross-border resolutions and systemically important financial institutions by year-end 2010.[11]

By that time, we in the United States were already working on parallel legislation to make many of those enhancements. The key components to reform, now embodied by the Dodd-Frank Act, were generally:

- Imposing a comprehensive reporting regime to ensure that regulators (and firms) would have a better understanding of the number, scope, and nature of derivatives trades;
- Reducing counterparty credit risks, by increasing clearing, margin and capital requirements;
- Reducing systemic risks by enhancing capital requirements; and
- Enhancing market integrity by improving business conduct, increasing transparency, and expanding authorities to police market abuses.

Each of these areas is complex, and the details have taken time to iron out. For example, one area I know of interest to many of you is how the supplemental leverage ratio may impact liquidity for some end-users. In the same vein, Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 exempted certain swaps from margin requirements.[12] Making sure the true "end-users" are not unduly negatively impacted by the new rules is an important goal. That said, I generally think the current rules do a very good job of that.

Now, after 6 years of discussions, proposals, and court battles, many of the rules are just now being finalized.[13] In one of the most important rulemakings completed since the financial crisis, the U.S. Prudential Regulators and the CFTC have recently finalized margin rules.[14] While some aspects of the rules have been practically mandated for years through safety and soundness supervision, the provisions technically are coming on-line over the next year or so.

Role of Margin and Capital Requirements

Ensuring swaps transactions have sufficient margin and capital is at the center of the reform effort—precisely because those who lived through it saw how dangerous the lack thereof was to the system.[15] But why is that? Why do margin and capital play such an important role in the experts' approach to addressing the regulatory failings of the 2008 financial crisis? In no small part, it is because they address the systemic breakdowns of 2008. Both serve the same ultimate goal of ensuring that parties are able to meet their financial obligations, but they each go about achieving their objectives in different ways.

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[11] G20 Leaders Statement: The Pittsburgh Summit (Sept. 2009).

[12] This mandate was implemented as an interim final rule, which became effective on April 1, 2016. See *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* Commodity Futures Trading Commission, 81 FED. REG. 636 (Jan. 6, 2016).

[13] Foreign regulators are engaged in a similarly slow process, as many of their rules are also not yet in effect, and may be yet again delayed beyond 2017. Silla Brush and John Detrixhe, *EU Weighs Softer Derivatives Rules as MiFID Delay Bogs Down,* BLOOMBERG, Apr. 16, 2016.

[14] *Margin and Capital Requirements for Covered Swap Entities,* Office of the Comptroller of the Currency, Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and the Federal Housing Finance Agency, 80 FED. REG. 74840 (Nov. 30, 2015); see also *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* Commodity Futures Trading Commission, 81 FED. REG. 636 (Jan. 6, 2016). In general, the Prudential Regulators (*e.g.,* the Board of Governors of the Federal Reserve System) are setting the capital and margin rules for the swap dealers and major swap participants under their purview, and the markets regulators (*e.g.,* the CFTC) are setting the same rules for the swap dealers and major swap participants under their purview. These rules are not the same, nor would necessarily I expect them to be, given the different regulators and regulated entities.

[15] See G20 Leaders Statement: The Pittsburgh Summit (Sept. 2009).

For the benefit of those watching at home, margin is just collateral. Just like the collateral of the home reduces the bank's risk of the borrower's default on a mortgage, so too does margin directly reduce the risk that the trading counterparty won't pay—often called counterparty credit risk.

Most commonly, this margin is broken into two components—initial and variation. The initial margin is what the participants pay at the beginning of the relationship. The variation margin changes as the values of the relevant trading positions change, such as due to the regular fluctuations of our many markets. As a party looks increasingly likely to pay up, the margin could and should increase to reflect that, because if it did not, the other party would be more exposed financially to the risk of its counterparty not paying—again, its counterparty credit risk.[16] However, margin often comes with a direct cost to the party required to post it. Margin is typically in the form of cash, Treasuries, or other extremely liquid, stable value securities. This provides a stable and known value, but it also provides effectively no return for the party posting it. It isn't able to help them right now, nor is it likely to grow much in value. This often leads many firms to resist having to post margin.

That said, because of its efficacy at reducing counterparty credit risk, margin has been a hallmark of capital and derivatives markets for nearly a century. Why? Because, at its most basic form, margin enables market liquidity in a highly efficient way. By posting margin, multiple parties can trade with each other without massive amounts of due diligence, a costly and time consuming endeavor. Put another way, without margin, parties are trading with each other only to the extent that they fully trust the other party will pay them back, even if they go bust.[17]

In the over-the-counter (OTC) markets, the amount of collateral required and the quality of collateral has evolved significantly over the past several years. Before the crisis, financial firms, of course, would regularly pledge collateral, but the amount was typically relatively low. Many non-financial firms previously were able to trade without pledging any collateral (the increased risk was just priced into the contract). To the extent collateral was pledged, it could be working assets.

Not requiring margin is effectively an embedded loan. There is nothing inherently wrong with embedding a loan in a trading transaction, but we should be clear about what it is in practice: the party not requiring margin is taking the risk that it will not get paid back. It is reasonable to expect that a financial firm in most circumstances will be able to manage the risks of extending that type of credit to an ordinarily sized, non-financial end-user. That is essentially their business, after all. Moreover, those trades make up a relatively modest part of the overall trading going on in these markets.

Since the crisis, and in response to regulatory efforts around the world, an increasing percentage of derivatives trades are centrally cleared. As centralized clearing has taken root, the total collateral used to support non-cleared derivatives has fallen.[18] Non-financial firms still generally aren't required by regulators to post margin or maintain specific capital.

Overall, the amount of collateral and the quality of the collateral required across the system has generally increased, in part driven by renewed oversight from banking supervisors and in part driven by market demands on counterparties, including through central clearinghouses. Thus, between the increase in centralized clearing and the increase in amount and quality of collateral in non-cleared trades, the risk

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[16] Here, for simplicity, I treat both initial and variation margin collectively as margin. However, it should be noted that the ratio of obligations between the two may be significant. And there is no clear-cut "right" mix. Policymakers may elect to require lower initial margin in return for requiring greater sensitivity and higher potential variation margin. This comes with increased variability in margin costs for participants. Conversely, increasing initial margin may be accompanied by decreased variation margin requirements. This may stabilize margin level for participants, but may also result in higher overall margin levels and costs.

[17] Notably, derivatives enjoy highly preferential treatment under the bankruptcy code, making them far more likely to be paid in the event of bankruptcy than other types of liabilities, such as pensions (or even secured creditors). This treatment may both incentivize the use of derivatives, but it also may lead to sub-optimal social or financial outcomes, something that U.S. Senator Elizabeth Warren has highlighted when proposing to repeal this treatment. See, *e.g., Interview of Elizabeth Warren,* U.S. Senator, C–SPAN, Nov. 13, 2013, available at *http://www.c-span.org/video/?c4473182/senator-warren-derivatives-seniority-bankruptcy*. For a review of some of the economic impacts of this special treatment, see Patrick Bolton and Martin Oehmke, *Should Derivatives Be Privileged in Bankruptcy?,* JOURNAL OF FINANCE (2015), available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2023227*. Preferential treatment notwithstanding, some might also say that the 2008 financial crisis proved that the ultimate guarantors of those private and implicit promises are the American taxpayer.

[18] International Swaps and Derivatives Association, Inc., *ISDA Margin Survey 2015,* at 3 (Aug. 2015) (reflecting a decrease from $5.34 trillion in 2013 to $5.01 trillion in 2014).

that a party will be unable to pay up on its trade is today much lower than it was just a few years ago.

Capital, by contrast, indirectly reduces counterparty credit risk by ensuring that a firm generally has enough assets to pay all of its reasonably foreseeable obligations. This is particularly important for a derivatives dealer, such as a bank or firm like AIG, since this protects from concentration risks that trade-specific margin requirements may not adequately address. Here, adequate capital requirements help supplement margin rules. If margin is the first line of defense, capital is the last.

Capital also has one big advantage over margin. Unlike margin, which typically produces little or no financial return for the posting party, capital is not pledged away, nor is it necessarily in super-stable, super-low yielding assets. It can, and often will, provide a modest return to the holder.

Disparate Impacts of Margin and Capital Requirements on Different Types of Firms

Before specifically addressing some of the concerns about market impacts of margin and capital rules, I want to acknowledge the distinct differences between firms engaged in swaps trading, and how margin and capital requirements might impact them differently.

First, there are the largest banks and bank-affiliated firms. For these firms, financial assets are relatively easy to come by. They are, after all, financial institutions with relatively low borrowing costs and often-excellent access to a wide array of assets.[19] They also have complex oversight and risk management systems (including sophisticated risk modeling systems)[20] that allow them to monitor and manage their cash-flow requirements. In addition, they have historically conditioned to having capital and margin requirements. For these firms, incremental increases on margin or capital requirements are not likely to have profound impacts on how they do business. Changing margin and capital rules can, however, impact their overall profitability to the extent that it may restrict their leverage and increase costs for accessing high-quality assets.

Next, outside of the handful of the mega-banks, there are the other financial firms. These firms are likely regulated by the Commodity Futures Trading Commission and the Securities and Exchange Commission. They have traditionally operated under much less proscriptive capital regulatory regimes than banks, a fact that was highlighted by the collapses of Lehman Brothers, MF Global, and Bear Stearns. In addition, depending upon their business, these firms may not have significant amounts of liquid assets readily available for posting margin. Of course, some of these firms are deeply involved in swaps trading, and may have material swaps exposures, while most do not. Some are very familiar with posting liquid assets as margin while others are not. Further, while some of these firms may have sophisticated trade and risk management systems, including complex modeling capabilities, most do not.[21]

Finally, we have the non-financial firms. They include farmers, agricultural firms, manufacturers, and thousands of other firms that we might think of as the true "end-users". If properly defined, these firms comprise a very small percentage of overall swaps trading. And for them, margin or capital rules would seem unnecessary, inappropriate, and unduly burdensome. In addition, many do not typically have liquid financial assets available to use for posting margin, nor do they typically operate under a concept of regulatory capital. Imposing these limitations may have profoundly negative impacts on their operations. That's why Congress and regulators have already generally exempted these firms from the margin and capital requirements.

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[19] In response to the financial crisis, however, regulators around the world, particularly banking and Prudential Regulators, have taken steps to improve the quality and quantity of capital held by financial firms.

[20] Bank regulatory capital requirements, and compliance with them, have in recent years become increasingly complex, and model-driven. However, the efficacy of these models to provide meaningful evaluations of risk is nevertheless limited in many respects. For example, even basic metrics, such as Value-at-Risk, may be significantly altered by revisions to how the calculations are made, or the values of the inputs. For a detailed case study of potential failures of risk modeling, please see *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses,* Homeland Security and Government Affairs, Permanent Subcommittee on Investigations, Majority and Minority Staff Report, at 165–213, (Mar. 15, 2013).

[21] One of the key issues facing a firm under U.S. rules is determining whether it has "material swap exposures." However, I understand that some non-bank financial firms may have difficulty in making such a determination without significant revisions to their oversight systems or outside assistance.

Regulations, Liquidity, and Costs

Many have worried that banking and derivative regulations may reduce the number of counterparties, decrease liquidity, and increase costs for market participants.[22] To date, I have seen no evidence of margin and capital requirements disrupting markets or increasing costs for "end-users."

Of course, concerns about the potential impacts of new rules on liquidity and costs are equally present in a broad swath of financial markets, including Treasuries, corporate bonds, and equities.[23] The results of the limited studies so far have been encouraging.

Despite dire prognostications, these reforms seem to not be negatively impacting liquidity. According to the International Monetary Fund, liquidity measures in the bond markets in the U.S., Europe, and even emerging market economies are generally better than 2007 levels.[24] For example, when experts at the Federal Reserve Bank of New York looked late last year at the corporate bond markets, they found that liquidity is better than it has been at any time since the financial crisis.[25] Bid-ask spreads are tighter than they have been in years and trading price impacts are way down.[26] All while dealer inventories have fallen.[27] So the sky hasn't exactly fallen—unless you're a bank with declining inventories and trading revenues. Even then, decreased bank revenues may be more of the results of stable asset prices, a near zero interest rate environment, and other non-regulatory factors.[28]

Coming back to the swaps world, despite dire warnings of the demise of all liquidity and skyrocketing costs, to date, there doesn't seem to be much of any impact on the real "end-users"—the farmers and manufacturers. Indeed, a recent study by the Bank of England found that enhanced swaps requirements from Dodd-Frank, including central clearing—which itself includes margin and certain other requirements on members—as well as trades through swap execution facilities, resulted in enhanced market liquidity and a significant reduction in execution costs.[29]

Additional facts bear out the story that effective derivatives regulation is beginning to work without imposing new negative ramifications on the markets.

First, the OTC derivatives market is still enormous. According to the Bank of International Settlements, the total notional amount of OTC derivatives outstanding at the end of June 2015 was $553 trillion,[30] about 79% of which involved interest rate derivatives.[31] The gross market value of these positions was $15.5 trillion.[32]

Second, true "end-users" are almost entirely exempted from new derivatives rules, including the margin and capital requirements.

Third, to date, I have seen no credible study demonstrating increased costs or burdens on "end-users" resulting from these regulations. The writing has been on the wall—even if not the final rules—for more than 6 years. Margin and capital have

[22] It is important to note that "liquidity" has no precise definition. For my purposes, I define it as the "ability to rapidly execute sizable securities transactions at a low cost and with a limited price impact." *Global Financial Stability Report,* International Monetary Fund, at 53 (Oct. 2015) ("IMF Global Financial Stability Report"), available at *https://www.imf.org/External/Pubs/FT/GFSR/2015/02/pdf/text.pdf*.

[23] For example, in the Omnibus appropriations bill this past year, Congress directed the Securities and Exchange Commission's Division of Economic and Risk Analysis to provide Congress with a report on the impact of the Volcker Rule and other regulations, such as Basel III, on "(1) access to capital for consumers, investors, and businesses, and (2) market liquidity, to include U.S. Treasury markets and corporate debt." As one of the drafters of both the Volcker Rule legislation and the multi-agency rule to implement it, I will be interested in this study's findings.

[24] *IMF Global Financial Stability Report,* at 58.

[25] Tobias Adrian, *et. al, Has Corporate Bond Liquidity Declined?,* LIBERTY STREET BLOG, Federal Reserve Bank of New York, Oct. 5, 2015, available at *http://libertystreeteconomics.newyorkfed.org/2015/10/has-us-corporate-bond-market-liquidity-deteriorated.html#.Vx2DtHopko0* (looking at corporate bond markets).

[26] *Id.*

[27] *Id.*

[28] *IMF Global Financial Stability Report,* at 67 ("Risk appetite and funding liquidity seem to be the main drivers [of bond market liquidity], but indirectly the results point to an important role for monetary policy.").

[29] Evangelos Benos *et. al, Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act,* Staff Working Paper No. 580, (January 2016), available at *http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf*. (finding significant cost savings in the interest rate swaps markets as a result of these changes).

[30] Bank of International Settlements, OTC derivatives statistics at end-June 2015, at 1 (Nov. 2015), available at *http://www.bis.org/publ/otc_hy1511.pdf*.

[31] *Id.,* at 2.

[32] *Id.,* at 1.

been increasing for years now, and yet end-users still seem to be able to trade what they need.[33]

Fourth, the mix of firms providing swaps trading services has been changing for a long time before the advent of new regulations. The largest banks unquestionably have traditionally enjoyed a huge advantage in the trading markets, with extremely low funding costs, large balance sheets, and sophisticated trading and risk management operations. Those advantages have helped drive consolidation here, just as it has in other financial services areas—and it is not unique to derivatives trading.

How margin and capital rules will impact that consolidation, however, remains unclear. I understand this Subcommittee has heard from some non-bank financial firms that new rules—particularly for capital requirements—may unnecessarily restrict their ability to engage in swaps trading.[34] On the other hand, some large banks themselves and outside consultants have started modeling out whether and how they might be better off spinning out some or all of their derivatives trading operations to avoid the new rules.

To me, it is at least worth exploring whether isolating derivatives trading operations in separately capitalized firms that are outside of the taxpayer-protected banks could be beneficial for the markets and to removing an implicit taxpayer subsidy for the largest participants. Nevertheless, I suspect the key funding and capital advantages of the largest banks will ultimately prevail as they have since well before the crisis.

In sum, the new rules don't seem to be changing much other than simply imposing moderately enhanced protections for counterparties at the cost of moderately higher margin and capital for the major players in these markets.

International Regulatory Coordination and Cross-Border Regulation

As the financial crisis unfolded, regulators around the world immediately recognized that swaps regulation needed to be effectively coordinated across national boundaries.

AIG was a New York-based firm whose London-based Financial Products unit brought down its worldwide operations. But this was not the first or the last U.S.-based firm to suffer from financial troubles resulting from trading done abroad. In fact, offshore derivatives trading has played key roles in collapses ranging from Enron to Lehman Brothers. And in 2012, it was the London-based trading group of JPMorgan Chase using "excess deposits" to trade illiquid credit derivatives that cost it approximately $6.2 billion. In each case, the U.S. firm was on the hook for losses.

Regulators have been acutely aware of these instances, and the risks of regulatory gaps and arbitrage. The Pittsburgh Summit laid out the blueprint for the G20. In the United States, Congress empowered the regulators by saying that they could regulate swaps trading that has "a direct and significant connection with activities in, or effect on, commerce in the United States."[35] This broad jurisdictional authorization was deemed critical, because, as a CFTC Chief Economist later put it, "risks taken by foreign affiliates, subsidiaries, and branches of U.S. parent companies are usually borne by the U.S. parent."[36]

The creation of artificial jurisdictional divides between different international regulators poses one of the greatest risks to effective oversight of these markets. The

[33] I note that much of the single name CDS market remains largely stalled. That said, to the extent that the products served a valuable purpose, I expect there to be continued use of other financial products to hedge credit risks, as well as continued efforts to restart the CDS products. The IntercontinentalExchange's buyside-centric CDS trading platform announced last August is a timely example. Mike Kentz, *ICE plans single-name CDS platform,* REUTERS, Aug. 31, 2015, available at *http://www.reuters.com/article/markets-derivatives-cds-idUSL1N1161A520150831.* In fact, in a headline that echoes from the run-up to the financial crisis, it was recently reported that due to "tightness" in the availability of some asset-backed securities, some investors may be increasingly turning to credit derivatives. See, Joy Wiltermuth, *Investors Turn to CMBS derivatives for liquidity,* REUTERS, Apr. 22, 2016, available at *http://www.reuters.com/article/usa-corpbonds-abs-idUSL5N17N4TL* (reflecting that total notional values in derivative CMBX contracts increased from $141 billion to $181 billion from 2015 to 2016).

[34] *See, e.g.,* CFTC Reauthorization, Before the House Committee on Agriculture, Subcommittee on Commodity Exchanges, Energy and Credit, 114th Cong. (2015) (statement of Mark Maurer, Chief Executive Officer, INTL FCStone Markets, LLC), available at *http://agriculture.house.gov/uploadedfiles/maurer_testimony.pdf*.

[35] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, § 722, (2010).

[36] Declaration of Sayee Srinivasan, Chief Economist, Commodity Futures Trading Commission, Mar. 14, 2014 (cited in *Securities Industry and Financial Markets Association, et. al,* v. *CFTC,* Civ. N. 13–1916, 5 (Sept. 16, 2013), available at *https://secure.fia.org/downloads/SIFMAvCFTCOpinion.pdf*).

largest financial firms have dozens, if not hundreds, of affiliated entities around the world, all designed to support the overall business. If a firm can avoid capital requirements or margin rules by simply shifting its trading, technology, or basic reporting structure to another jurisdiction, it may likely do it. But the risks may still remain where they were before. Policymakers and regulators in the United States should be cautious about exempting foreign branches or affiliates of U.S.-based firms from any of our rules, but margin and capital in particular.[37]

To date, the U.S. regulators have been extremely active in collaborative international efforts to impose largely similar derivatives oversight regimes around the world.

U.S. policymakers and regulators should continue the work, and the recent mutual recognition determination is a great step forward. However, I would strongly recommend against further delaying implementation of critical reforms on the grounds of imposing rules only where there may be complete international consensus. Foreign regulators are no more immune to lobbying efforts from the largest financial firms than those in the U.S. And we must be cognizant that multinational firms may seek to play domestic and foreign regulators off each other.

Last, while different regimes may be similar, they are not identical. While some regulators may focus heavily on margin, others may focus more on capital. Some regimes place greater emphasis on reporting requirements than others. This is natural, as it is within our fifty states to see differences in any number of regulatory areas.

Path Forward

U.S. regulators and policymakers should not forget the lessons of the past decade, where inadequate regulation of derivatives blew whale-sized holes through the balance sheets of some of the largest financial firms in the world, forcing regulators and U.S. taxpayers to step into the markets with trillions of dollars just to save the world's economies.

It seems only fitting that, in the aftermath, regulators have worked together to develop comprehensive regulatory regimes to:

- Improve reporting of derivatives so firms and regulators can better understand their exposures and risks;
- Reduce counterparty credit risks by pressing for more centralized clearing and imposing basic capital and leverage restrictions; and
- Reducing systemic risks by imposing heightened capital and leverage requirements on financial firms.

These are important goals. I urge you to keep the pressure on the regulators to get the job done. We are in mile 25 of this marathon. Now is the time to finish implementing these essential rules to protect U.S. businesses, municipalities, and families. I have confidence that, with your support, our regulators will be able to implement smart and effective derivatives rules that will continue to promote—not hinder—our economy.

Thank you for the opportunity to speak with you today, and I look forward to any questions.

The CHAIRMAN. Before we go into questions, I want to remind people that any Member may submit their opening statement for the record. I should have mentioned that prior to the testimony, I

[37] U.S. regulators have proposed to link application of many aspects of the Dodd-Frank-related reforms to the presence or absence of a "guarantee." See, *e.g., Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, Commodity Futures Trading Commission,* 80 FED. REG. 41376 (July 14, 2014). Legislators and experts have long expressed concerns that this could easily lead to the "de-guaranteeing" of swaps, while not changing any of the fundamental relationships between affiliated entities. See, *e.g.,* Letter from Jeff Merkley, U.S. Senator, *et. al,* to Hon. Gary Gensler, Chairman, CFTC, *et. al,* July 3, 2013, available at *https://www.merkley.senate.gov/news/press-releases/senators-urge-cftc-sec-to-close-major-swaps-loophole-and-prevent-bailouts-from-implied-us-guarantees-on-swaps;* see also Letter from Americans for Financial Reform to Hon. Tim Massad, Chairman, Commodity Futures Trading Commission, and Mary Jo White, Chair, Securities and Exchange Commission, Nov. 25, 2014, available at *http://ourfinancialsecurity.org/wp-content/uploads/2014/11/De-Guaranteeing-Letter1.pdf.* The CFTC sought to address some of these risks by finalizing guidance on its definition of "U.S. person" in July 2013. *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, Commodity Futures Trading Commission,* 78 FED. REG. 45292 (July 26, 2013). These risks could also be more effectively addressed through the imposition of appropriate margin requirements for trades done by foreign affiliates.

apologize, but anybody who has an opening statement is certainly welcome to submit it for the record.

I would like to remind Members that they will be recognized for questioning in order of seniority for Members who were here at the start of the hearing. After that, Members will be recognized in order of arrival. I appreciate Members' understanding.

Mr. Lukken, so I understand that capital requirements are important to the big banks, but this is the Agriculture Committee. Why should our nation's farmers and ranchers be concerned?

Mr. LUKKEN. Well, in the futures markets, a significant amount of the cleared business runs through a bank-affiliated FCM. If you look at the stats the CFTC puts out, it is somewhere in the order of 87 percent of the cleared products come through bank-affiliated FCMs. And so this is going to have knock-on effects that will affect agricultural customers, who will have to pay more as a result of that. Many of them are using bank-affiliated clearing members to clear some of their business.

In addition, there is less capacity on behalf of these non-bank affiliates. So even though, if they reach a capital constraint because of the leverage ratio, there is not capacity elsewhere to accept these types of positions in non-bank-affiliated FCMs. So these costs will have to be passed on to customers. It's going to be more than a ham sandwich, as Mr. Gellasch indicated. I mean the numbers are significant. We are estimating somewhere in the order currently of $32 to $66 billion of costs will be as a result of this. So those costs will have to be passed on in significant ways to customers.

I would like to make the point too that this is not just talking about swap products that were in the over-the-counter markets that have come into clearing, this is affecting futures products; products that have nothing to do with the financial crisis are now being taxed as a result of these provisions. That affects farms directly and users directly, and should be of concern to this Committee.

The CHAIRMAN. Thank you. Mr. O'Malia, in your testimony, you stated that the impact of the new rules on individual business units or product areas could be disproportionate to the difference between a bank choosing to stay the course or exit the business.

Generally speaking, what drives the banks' capital allocation decisions?

Mr. O'MALIA. Right now, it is the rules. The rules are having a huge impact on where they are going to allocate capital. And as Walt pointed out in his testimony, and in mine, the leverage ratios are a very good example of that. These requirements are going up, and all of these rules in a cumulative impact are not being fully assessed. So we have a multitude of these rules being developed now that are going to be implemented over the next 4 years that individually have serious consequences to the investment decisions and the capital decisions that each of these banks are going to have to make, which will have pass-on effects. I can tell you, in developing these rules at the CFTC, we were very cognizant of how this would impact end-users, and we worked very hard to make sure that the margin rules did not impact end-users. That is not the case with the capital rules. There is no exemption in the U.S. capital rules for end-users.

The CHAIRMAN. Mr. Deas, the concerns you shared in your testimony are highly technical and nuanced. Did the Prudential Regulators consult with the hedgers who use derivatives for risk management purposes to understand how the rules would impact your ability to use these markets, and do you think that the regulators understand your concerns?

Mr. DEAS. Mr. Chairman, thank you. Well, certainly, both the Chamber and the Coalition for Derivative End-Users have been very active in submitting comment letters and other ways to make the Prudential Regulators aware of the concerns of end-users, but I would have to say that there has not necessarily been a very active two-way dialogue in that regard.

The CHAIRMAN. Gentlemen, thank you for your testimony.

I now recognize the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. DAVID SCOTT of Georgia. Okay, thank you, Chairman Scott.

I would like to see if we could get to this issue of the cross-border. I mean in each of your testimonies you all touched upon it, and it is a very, very critical issue.

Now, we have been wrestling with this equivalency situation with the EU for the last, seems like 2 years. It has just been ongoing, it was supposed to have been resolved last June, then it skipped and they said we will resolve it in October, the deadline was stretched to December. So where are we now? How serious is this? Mr. Deas, you touched upon it, and each of you have, but there is something else that worries me about this. You take other countries that the European Union has dealt with on equivalency, you take countries like Singapore that have the same robust, strong regulatory regime as the United States, Australia, as the United States, and they have EU equivalency. Now, what is going on over there? Why is this discrimination happening by the EU to our United States, when they are allowing other regimes with the equal robust regime to come in and get that equivalency? Is there something rotten in the cotton that we are not hearing about here, because what you have, to me, is you have the United States and you have the European Union are the two mightiest markets here, and it could very well be, maybe European Union is saying, maybe we need to cause a little more difficulty here, so that they can get a gain on the competitive edge. Am I right or wrong about that?

Mr. LUKKEN. I will take a first shot at that. I mean this is a very important issue for our industry, because it is a global marketplace, as you mentioned. The EU and the United States have reached a tentative agreement on that, and that is still working its way through the European Commission and the European Parliament, but it has to go into effect by a deadline in June. The problem is that there was a lack of transparency and lack of a process involved with this. Something that should have, as you mentioned, taken months, took years in order to work its way through.

That was the derivatives side. The securities side is still not decided. The SEC and the EU have not reached a decision on equivalence on the securities clearinghouse side. So this is still playing itself out. What was as a trade association tried to say is let's develop a process. We have due process here in the United States, the CFTC has to abide by certain APA recognition or APA transparency. There should be a process developed here so the EU and the U.S. can enter into these decisions, people can voice their concerns, and we can quickly get past these things.

But equivalence does not mean exactly the same. Equivalence means that these things are comparable, and we have the same outcomes. That is where we tend to stumble between the EU and the U.S.

Mr. O'MALIA. Ranking Member Scott, this is a great issue, and as Walt pointed out, it is a global market and, therefore, we need global rules. We have been working very hard to make sure to minimize the differences between the rule-sets, and to ensure that you can have comparable regulation. That is what was set out in the G20 objectives. That is what we believe is the outcome in many of these regulations, as you pointed out, with Singapore, the EU as well.

These rules are not going to be identical. You cannot read them word-for-word and come up with identical rules, but the outcomes are the same. And so we are pushing very hard, whether it is data, whether it is trader execution, how you comply on the firm's buy-side, sell-side, end-user, it does not matter. We are all working together to make sure you have comparable rules.

One recent frustration is, and I touched on this in my testimony, is the CFTC's own rules on cross-border have been inconsistent. On one hand, they put out the guidance 2 years ago that really kicked off some frustration globally about equivalence with the cross-border equivalence decisions coming—or that need to come as a result of the non-margin rules—or the margin for non-cleared rules, excuse me, they have a different position. The definition of *U.S. person* is different. So we would urge the Commission to: first, finalize its rules, and then be consistent with the Prudential Regulators' regulations that are already out. And then we probably ought to go back and re-evaluate the current guidance that they have issued.

Mr. DAVID SCOTT of Georgia. Right. My time is up, Mr. Chairman. If we have another round, I would certainly like to come back and ask what impact this controversy is having on our end-users.

The CHAIRMAN. We should have time for another round.

I now recognize the gentleman from Texas, Mr. Conaway, the big Chairman, for 5 minutes.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

Mr. CONAWAY. Well, thank you, Chairman. And full and fair disclosure, Austin and I finished up the mark-up—last night, or early this morning—at about 2:45, so I am not necessarily hitting on all four cylinders.

Belt and suspenders is a phrase that CPAs use a lot, and I am a CPA, but as I look at this, net stable funding ratio, supplementary Basel 2.5, Basel III, capital surcharges, at what point does it get to be too much? Are we overlapping these kind of things? And so that is the question, that is more broader to look at and step back and see now that we have all these rules in place for the most part, what is it we have actually done to ourselves, and how has this actually stopped any kind of a meltdown, going forward.

And I would like to get in the weeds a little bit. Scott, in your testimony, you talked about the ability of a bank to use internal models to calculate their capital requirements. If that is eliminated, then it is estimated that they would have to come up with 2.4 times as much capital as their internal modeling would have described. Are internal models that bad? That seems like a pretty dramatic differential between the way the regulators would want and the way the banks have seen, because they are responsible to the shareholders at the end of the day as well. What causes that big difference?

Mr. O'MALIA. Yes, well, it is important to put it in a bit of perspective. Following Basel II, regulators came up with the idea that, actually, you should have more risk-sensitive models appropriate to the bank, and they allowed for internal models to be used. And these are supervised, overseen models. These are not out of sight and out of mind. The regulators get a look at these. And they were developed to be more risk-sensitive, which is the appropriate evaluation. In the recent submission on the FRTB, fundamental review of the trading book, they have a higher standard for internal models. They have potentially reduced the ability to use internal models, and the difference on various asset classes could see a sizeable increase in capital requirements, and as you noted, and our research shows, it could be as high as 2.4 times more capital.

There is no perfect model, and we think that internal models should be used, and we are in favor or making them more transparent and working with the regulators to ensure that standard data is used, benchmarking is used, to make sure that they have a high level of confidence in the models so they can be used. If you go to a standard model, they are less risk-sensitive, more conservative, and will require more capital. And we want to make sure that we don't have kind of a standard model they used, kind of a one-size-fits-all which is inappropriate for the industry.

Mr. CONAWAY. Got you. Mr. Gellasch, you mentioned, and pardon me if I mispronounced your last name, a ham sandwich.

Mr. GELLASCH. Yes.

Mr. CONAWAY. Whose hide did that ham sandwich come out of?

Mr. GELLASCH. Pardon?

Mr. CONAWAY. Whose hide did that ham sandwich come out of?

Mr. GELLASCH. The banks'. Actually, they are the ones who actually have——

Mr. CONAWAY. What was their profit margin before the ham sandwich?

Mr. GELLASCH. So that is, actually, a really interesting question. So if you——

Mr. CONAWAY. I guess there is a profit margin too.

Mr. GELLASCH. Pardon?

Mr. CONAWAY. Is it okay for the banks to make money?

Mr. GELLASCH. Absolutely.

Mr. CONAWAY. Okay.

Mr. GELLASCH. Absolutely.

Mr. CONAWAY. So that ham sandwich cost didn't get passed on to the end-user?

Mr. GELLASCH. We don't know. And so out of $100,000 swap, the $7½ or so of the incremental cost of having it——

Mr. CONAWAY. Is that a number you would multiple by—to get to the $8 trillion? In other words, the ham sandwich is a pretty trivial amount, obviously, but do they do a lot of $100,000 swaps?

Mr. GELLASCH. No, but a lot of end-users do. And so you start to talk about $100,000 swaps or $1 million swaps or $100,000 swaps, the actual incremental cost here is just the incremental cost of, whether or not it is borrowed money or whether or not it is their own money. That is the difference between the capital. So that is actually the number we have to worry about. It is not the total amount of capital that they have, it is the cost of that being borrowed money or——

Mr. CONAWAY. Give me a perspective. I know what a ham sandwich is, but what was the profit margin to the bank before the ham sandwich, and is the extra cost of the ham sandwich worth them staying in the business?

Mr. GELLASCH. So, yes, and the answer is almost assuredly yes. And so the market risk for them was $1,000 on the example I used, so the market risk was $1,000 for them. They may very well charge, we are talking about hundreds of dollars. So the incremental cost to them is literally a few percentage points.

Mr. CONAWAY. Okay. They charged $100 for $1,000——

Mr. GELLASCH. They may charge $100 for $1,000 to be willing to take that interest——

Mr. CONAWAY. And you are pretty confident that that charge won't go to $107.50?

Mr. GELLASCH. I can't say I am——

Mr. CONAWAY. To the end-user.

Mr. GELLASCH. So the question is how much of that will be passed on, and the answer is we haven't seen it. So a lot of these rules have actually already been——

Mr. CONAWAY. Based on your background, have you ever seen anything that wasn't passed on?

Mr. GELLASCH. Yes. To the extent that there are limitations on that. I would say, we do have, actually, a relatively competitive environment. One of the things we have actually seen as some of these rules have come on is in the interest rate environment, we have actually seen bid-ask spreads narrow, we have actually seen liquidity in some cases actually improve. We have actually seen costs come down.

Mr. CONAWAY. You keep using the word, and I am way over my time, you keep using the word *some* and I am just trying to get a perspective on that, because you are the only person who has ever come in here, other than a regulator, that is happy with the rules as you seem to be.

And I yield back.

Mr. GELLASCH. I wouldn't actually say I am as happy as I am, but I do think that they are generally very good rules.

The CHAIRMAN. All right, the chair now recognizes the gentlelady from Arizona, Mrs. Kirkpatrick.

Mrs. KIRKPATRICK. Thank you. Mr. O'Malia, I want to follow up on your comment that one-size-doesn't-fit-all in terms of capitalization. Can you give me an example of what you mean by that?

Mr. O'MALIA. Sure. Thank you for the question. So the analysis we have been doing on the FRTB, and we would be happy to provide it, there is an annex in there that does elaborate a little bit more on my testimony.

Mrs. KIRKPATRICK. I would appreciate that.

Mr. O'MALIA. Yes. So the analysis we looked at, using the internal model, we believe that the FRTB capital model will increase capital requirements, risk-weighted basis, 1.5 times. Without the ability to use internal models, we believe that could go to 2.4 times the capital requirements.

Now, it is not completely binary. Some banks may be able to use capital models, some may not, but it is in that range of the capital increase that we have estimated for the FRTB rule that was just recently released.

Now, it would also have, due to our estimates, impacts on FX, foreign exchange, you could see in that asset class as well as securitization and equities. But as an example, and kind of at the high end, FX could go up by 6.4 times, based on our analysis. Now, this would be a big impact, and people would use FX hedgers, end-users for commercial operations for the global operations. Right? They are paying salaries, recouping revenue, raising money in different countries. That would have a big impact. And keep in mind, these are global rules. These are not just U.S.-specific rules. So this affects all the global exchanges in dealing with this. So this is not just U.S.-specific. But those are specific examples that I could give you, and we have plenty more details in our more thorough study that we have included.

Mrs. KIRKPATRICK. I would appreciate that. Has there ever been a situation where a market participant had insufficient capital, and if so, what happened?

Mr. O'MALIA. Under the Basel——

Mrs. KIRKPATRICK. Market participant.

Mr. O'MALIA. Yes, well, they have had regulators who insist they raise that capital requirement.

Mrs. KIRKPATRICK. But what really happens aside from that, I mean in impacts?

Mr. O'MALIA. You have a conversation with your regulator and they expect you to put more capital behind it.

Mrs. KIRKPATRICK. But can you give me an example of where there was a market participant who did not have enough capital?

Mr. O'MALIA. We can——

Mr. LUKKEN. I would just——

Mrs. KIRKPATRICK. Any——

Mr. LUKKEN. I mean——

Mr. O'MALIA. Yes.

Mr. LUKKEN.—the prudential banking regulators would require you either to go out in the debt markets to raise more capital, or issue stock to raise more capital, but you would be out of compliance with prudentially regulated regulations that require a certain amount of minimum capital, and——

Mrs. KIRKPATRICK. I guess what I am trying to find out what is a commonsense sort of approach to good capitalization? So you are basically saying it is in the hands of the regulators. I get that because of the regulations, but I am trying to find out are those regulations sensible, is there another standard for looking at what makes good capitalizations. That is what I am trying to get at.

Mr. O'MALIA. Well, in that case, you and I are looking for the same thing. What we see is the individual rules are being promulgated and we are watching them individually. What we haven't done, and what we would be strong in favor of, is kind of looking at the comprehensive. And we have to look at the individual business lines as well. The leverage ratio, for example, is a tax on clearing that is diametrically opposite with what the market regulators have kind of urged market participants to do; put more into clearing, which is the right thing to do. But then the capital rules kind of send the conflicting message in tax and clearing by not recognizing the initial margin as risk offsetting.

Now, the individual rules we will look at and try to assess the impacts on individual businesses, and those rules are being developed currently. Right? We haven't seen the final rules in most cases, and they will be developed and implemented over the next 4 years. So we are trying at this point, at this important point, before they are fully implemented, let's understand the real ramifications of the individual rules on the individual businesses, and let's do a cumulative impact to really understand the broader economics.

Mrs. KIRKPATRICK. Thank you. That is what I am after. And my time is running out, but I would appreciate more information on that. I will tell you that it has been my experience that, in crafting legislation and regulations, too many times we do think that one-size-fits-all, and it doesn't work. So I appreciate the panel's testimony.

I yield back.

The CHAIRMAN. The chair recognizes the gentleman from Mississippi, Mr. Kelly, for 5 minutes.

Mr. KELLY. Thank you, Mr. Chairman. And, Mr. O'Malia, in your testimony you say that we need to understand the cumulative effect of these regulatory changes on the economy before they are fully implemented, and I agree with you. However, I am assuming the proponents of the changes would argue that the potential adverse effects of the economy could be much greater if we don't expeditiously implement the changes. How do you respond to such claims?

Mr. O'MALIA. Well, we have time to do that now. There is nothing to stop these rules from going forward and doing the cumulative impact assessment right now. These are Basel rules, they are going be promulgated and moving forward. The leverage ratio, fundamental review of the trading book, are near final anyway but they have time to be implemented over the next 4 years.

We do believe that a cumulative impact assessment, and really looking at the individual business line impacts, would be informative to understanding the ramifications.

A lot of people, and with all due respect to Mr. Gellasch and his ham sandwich, a lot of these rules have not been fully implemented and costed-in. As I mentioned, the non-cleared margin rules have yet to take effect. Those are going to have a $300 billion impact. These are CFTC numbers, not my numbers, CFTC numbers. And those are going to be real ramifications. The capital rules are not finished yet, and are going to be phased-in over the next 4 years. We haven't seen the full price of this. We have seen what the cost of clearing has done. We have, SIFMA AMG has put out and surveyed their members, $34 trillion under management from those asset managers, pension fund managers, and they are saying from their membership, yes, we are seeing price increases, these are going up, we are seeing fewer people that we can deal with in this derivatives ecosystem. And it is an ecosystem. Right? You need risk managers and you need hedgers, and all of that has to work together. And these capital rules, as I said earlier, aren't exempting end-users. Right? These costs will be passed on.

Mr. KELLY. And kind of going back on your line, and following up with what Chairman Conaway talked about, it is easy to say when things don't generate income or revenue, that those costs are passed on to the banks. However, I spent quite a bit of my time in the districts speaking with banks and constituents, and my experiences have been that most of the time, whether it is a ham sandwich or a Mercedes Benz, that that cost is generally always passed on to the consumer, because the margins keep getting thinner in this world and generally that is passed on to the consumers, which basically blocks people out from being able to get income that they need. Do you agree?

Mr. O'MALIA. I fully agree with you, sir.

Mr. KELLY. Thank you. Mr. Lukken, why did the G20 call for the imposition of margin and higher capital requirements, and how does the posting of margin and holding additional capital reduce systemic risk?

Mr. LUKKEN. Well, the G20 looked at the example of the futures markets and how well they worked during the financial crisis. And when Lehman Brothers went down, the futures business easily moved to other clearing members that were healthy and able to accept those positions. So that ability to port something from a failing institution to a healthy market participant allowed the markets to function, to price discover during that process, while some of the over-the-counter markets froze up with uncertainty.

And so they looked at that example and said clearing seemed to work during a crisis situation. Let's consider bringing some of these products in a more transparent, regulated environment that allows for daily posting of margin, so when people put on transactions, they are able to put up this performance bond that ensures there is money sitting there, cash money regulated by the CFTC, in case one of those parties defaults. And that is the first line of protection. You talk to any clearinghouse, talk to Chairman Massad of the CFTC, it is always there in a crisis.

And what we are asking is simple math. Recognize that it is always going to be there during a default, and subtract it from the exposure that the bank has to the clearinghouse. It is cash. It is easy to measure. It is simple math. So please do that so that we are not taxing clearing as these products come into this more healthy, regulated environment.

Mr. KELLY. And I had another question, but I am going to run out of time. I thank all you witnesses for being here and taking the time to explain this extremely complex math to most of us regular folks.

And, Mr. Chairman, with that, I yield back.

The CHAIRMAN. The chair now recognizes the gentleman from Oklahoma, Mr. Lucas, former chair of the full Committee.

Mr. LUCAS. Thank you, Mr. Chairman.

And one of the great things about the Committee hearing process, as the Committee knows, and I am sure our witnesses have experienced, there are issues that are so important that they have to be discussed and discussed and discussed in order to burn it in.

So in that regard, Mr. Lukken, I would like to turn to you, and be specific about once again discussing in the many instances where clearinghouse members or banks that are subject to the Basel capital rules which require them to hold that capital against the guarantee they provide for their clients. As I have personally repeatedly said in many of these hearings, and in conversations even with Chair Yellen, we can all agree that banks have exposure in the event their clients are unable to fulfill their obligations, and should hold capital against that. We all agree on that, but I am concerned about my constituents in the energy and ag business, how are they going to find access to their risk management tools if the margin posted isn't even recognized under the Basel leverage ratios. Would you expand for just a bit on that because, after all, as has been discussed here earlier, if the banks don't want to participate in this, they don't have to, reducing competition and reducing the opportunities for my constituents in the real world. Would you expand on that?

Mr. LUKKEN. And the effects are not theoretical. We have already had four bank clearing members pull out of the business, citing that capital is too expensive to continue on in this world. There are others on the sidelines that are waiting to determine whether these will be implemented, and whether it will be fixed by the time these provisions go into effect in 2018.

So this has real consequences on end-users. They may have less access to clearing members because there are less choices, and as we see in the numbers I cited, they are decreasing significantly over the last several years. And that will expedite itself if this is not fixed in our community.

I would want to mention too the costs as banks measure this, they measure things in business units. As one of these banks may look at this, they will look at the clearing business itself and realize that the capital that that clearing business has to rent in order to make a return is so expensive because of this lack of an offset that it is just we are not willing to do that within that business unit of the bank. We have other more profitable parts of the bank that we will put that capital towards, whatever that might be.

And so I realize that we talk about some of these costs, but the cost to the clearing business is significant. It is not a hugely profitable part of these banks, and so these types of costs are really bearing down on whether these clearing members decide to stay in the business or not.

Mr. LUCAS. And access is critically important to my constituents. As we have gone through this downturn in the last 6 months broadly in ag and energy prices, had those tools not have been available to my folks back home to soften this, we would be in dramatically worse shape.

Let's go one step further. In your testimony you note, referencing Basel III and the capital requirements, you note that the consolidation of the futures commission merchants, something like 60 percent over the last 10 years, expand for a moment on, in addition to the capital issues, what is driving this consolidation within the industry?

Mr. LUKKEN. I think it is fixed costs. I mean if you can look at whether it is the fixed costs of regulation, more volume is necessary to flow through these intermediaries in order to make it a profitable business. And so you have people who are shuttering businesses, people who are merging, so you are seeing that over that period of time where people are deciding to either just get out of the business itself or to offer to try to merge those businesses in order to get more volume to go through those things.

So that is regulator costs, we realize that, and some of those are very important and needed, don't get me wrong, but it is capital costs and it is this cumulative effect that Scott mentioned. We have to look at all the costs that are being thrown onto this system, and that is going to cause less people to be participating in that system, by definition.

Mr. LUCAS. So ultimately, if we have an environment where no one wants to participate, that means the opportunities for my farmers and my energy folks are reduced, and those few opportunities come at a higher cost, and they ultimately suffer the real prices.

Mr. LUKKEN. Absolutely.

Mr. LUCAS. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The chair now recognizes the gentleman from Illinois, Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman. And thank you and all the witnesses.

Kind of a follow-up to my colleague, Mr. Kelly, and my colleague, Mr. Lucas', line of questioning. Mr. Lukken, now, if the banking regulators won't recognize the customer margin as reducing the clearing members' exposure, are the Basel standards actually discouraging, in your opinion, the collection of client margin, and thereby, as Mr. Lucas talked about, the effect on his constituents and my constituents, and all of our constituents, who want to use this process, are they discouraging clearing?

Mr. LUKKEN. Yes. We are already seeing certain clearing members divorcing themselves of clients in order to reduce the capital burden in this area. So as I mentioned, some have gotten out of the business. But, beyond that, there are people who are shedding clients, off-boarding them in order to get into compliance with the standards. So yes, yes, it is happening, and yes, it is discouraging clearing.

Mr. DAVIS. So you are reducing the amount of clearing members that would want to participate in this process for our constituents to participate in the futures, the options, the swaps market, *et cetera,* therefore, reducing the number of clearing members, which wouldn't that ultimately raise the cost?

Mr. LUKKEN. Absolutely, and that is what we are seeing.

Mr. DAVIS. So much more than a ham sandwich.

Mr. LUKKEN. Absolutely. And like I said, this is being viewed from the futures side of the business, which is normally a small part of these institutions. So it is much bigger cost for those business segments than it is for the entirety of the bank, which is having a huge impact.

Mr. DAVIS. Okay, so premium ham sandwich or the whole hog. Well, actually, the whole hog would probably cost less on the market, right?

Mr. GELLASCH. Just to add a quick interesting point on that. One of the things we have seen is actually the consolidation is a real concern. It is actually one that is not unique to this. The largest financial institutions have cheaper borrowing costs and economies of scale that smaller firms simply do not.

When you talk about whether——

Mr. DAVIS. So you would rather us just have the larger firms?

Mr. GELLASCH. Absolutely not. The challenge there is the same thing we have in this context as we do all other business lines that banks and financial firms are engaged in. We have seen a consolidation that is not just in the derivatives and not just in these markets, but in others as well. We have seen that in commercial banking as well.

One of the things that is really important here is when we talk about what that means, what that consolidation means. Does it mean higher costs or not. Actually, I would look at is the actual cost of doing a trade, what that means in terms of pricing, what that means in terms of bid-ask spread for doing that trade, and what the implementation cost is for that trade. And actually, by those measures, actually, costs are coming down, notwithstanding this consolidation. So I just want to make that point.

Mr. DAVIS. So costs are coming down, consolidations are happening, we have in the banking sector, as we have seen in the rural area that I represent, there aren't as many community banks anymore. It seems to me that we are getting to the point where we might actually have too many, we are getting to the point where we only have the banks that are too big to fail. Are we going to see the same thing on the clearing side, Mr. O'Malia?

Mr. O'MALIA. I just find some of this to be, on one hand you have the argument that this doesn't cost anything more than a ham sandwich, then you are talking about massive dislocation and concentration of things. The regulators intended for these to have change behavior. Right? They imposed capital requirements to increase the quality and the quantity of capital. The costs are going up, and they are not going up by a little bit or a ham sandwich, they are going up by billions of dollars. And to Walt's point, there is consolidation and there are people making decisions about whether they are going to be in this business or that business, and there will be thousands of layoffs as a result of that. That is going to have huge ramifications, not to mention the service they are provided.

And whether it is the Coalition of End-Users or it is SIFMA AMG, they are all raising their hand saying, "Hey, regulator, pay attention, the cost to serve my customers or to manage the pension funds that we do, is going up. Clearing costs are going up." The fact that you don't—as a result of capital. And they have pointed at the capital rules.

Mr. DAVIS. And my constituents——

Mr. O'MALIA. So you can't have it both ways.

Mr. DAVIS. And my constituents are losing access to be able to participate in this marketplace too, correct? And, Mr. O'Malia, I have a question for you really quick. You stated in your testimony that we need to understand the cumulative effect of these regulatory changes on the economy before they are fully implemented. I agree. You just briefly touched on that a second ago. I am assuming the proponents of these changes would argue that the potential adverse effects on the economy could be much greater if we don't expeditiously implement the changes. I mean can you expand on that and your testimony a little bit?

Mr. O'MALIA. Yes. Well, I guess the proponents shouldn't worry if it is only going to cost a ham sandwich, they shouldn't be afraid of the facts on this one. So let's move on, let's do a cumulative impact study if there is no harm there. So the facts are going to tell us where this thing ends up, and at the end of the day, we will all be better informed as a result of that. And that is exactly where we should be. We should understand the cumulative impact as well as the individual business line impact.

Mr. DAVIS. Thank you. My time has expired, Mr. Chairman.

The CHAIRMAN. The chair recognizes the gentleman from California for 5 minutes.

Mr. LAMALFA. Well, thank you, Mr. Chairman. And my constituents would rather that we talk about a tri-tip sandwich, given the ranches we have up there, or maybe move on from the sandwich.

Mr. O'Malia, we were talking earlier about the CFTC has yet again to put out the final rule on cross-border trades, and the implementations that are going to be required for that in approximately 4 months, is my understanding, which is a very short window of time for the final rule. And so important compliance decisions are also needed as well. So if the CFTC does not come to a decision in this timeline, and the discussions continue to drag on, what would the effects be on the uncleared swap marketplace?

Mr. O'MALIA. Confusion, in one word, but it is more complex than that. So we would appreciate the CFTC moving expeditiously to put out its final rules. We would like them to be as consistent as possible with the global framework.

Mr. LAMALFA. So say it again. You don't want speed, you would rather have——

Mr. O'MALIA. No, we do want speed. We want both.

Mr. LAMALFA. You do want, okay, I heard wrong.

Mr. O'MALIA. We want speed and consistency. Obviously, with the end deadline a few months away, it is important that we know what the final rules are going to be so we can draft the appropriate documentation to link the industry together.

Mr. LAMALFA. How possible is it going to be that it is going to be speedy and consistent at this point?

Mr. O'MALIA. Excuse me. Depends on how soon they get this out. If we have the final rules, excuse me——

Mr. LAMALFA. Yes, take a moment.

Mr. O'MALIA.—sooner rather than later, then we will be in much better shape. What we are trying to do is——

Mr. LAMALFA. Well, how do you feel they are doing on issuing them at this point? Do you think they are going to be pretty snappy getting them out, or——

Mr. O'MALIA. We don't know. It is up to the Commission to figure that one out. And we hope sooner and we hope consistent, consistent with the other regulators.

Mr. LAMALFA. Does it have to be a difficult process, or it would be pretty straightforward?

Mr. O'MALIA. I think they are making it more difficult than it is.

Mr. LAMALFA. Yes.

Mr. O'MALIA. It should be more consistent. And unfortunately, the CFTC is in a tough position. Either they are going to submit rules that are consistent with their original guidance 3 years ago on cross-border, or they are going to submit rules that are consistent with the Prudential Regulators on non-cleared margin. And if they go with the Prudential Regulators, then they are inconsistent with their original cross-border guidance on who a U.S. person is, and some of these other factors. So either way, they really need to kind of step back and ultimately revisit their entire cross-border strategy, because it is making the entire process more complex. It does create some ill will in Europe, which is going to create a pushback.

Mr. LAMALFA. Yes. How big has that pushback been? I mean we have been hearing about that for at least a year or more that it is a threat. What has the effect been so far, or has it really come to pass yet?

Mr. O'MALIA. Well, obviously, the CCP recognition and the equivalency took 3 years to get through. I think it is really important. Nobody wants to have rules that create gaps. Right? We want, and I can understand, and having been a former Commissioner, Walt has been a former Commissioner, you want to draft rules that are consistent, and you want to make sure that you have thought of everything. But that doesn't mean that you regulate everything. And we can rely on the global partners here because, at the end of the day, they have really developed rules that are going to achieve the same outcome. Data reporting, largely the same in the outcome, but they can't share data because they don't have it in a format that works. Trade execution is a big factor that is coming into play with the European rules around the corner. We have seen fractured liquidity in the markets today. Are you going to fix that or are you going to sustain that, is a big question. Are you going to recognize a global liquidity pool or are you going to have regulatory friction that divides the markets.

The non-cleared, I would have to give regulators a lot of credit on the non-cleared margin. Those rules are as consistent as any rule-set they have developed yet today. And the goal has been to make sure that we have a global non-margining framework. So I do compliment the regulators on that. Now it is down to the final strokes. Let's put forward a cross-border system that recognizes that they are nearly identical, and we move on from there so our members can deal with these rules, and you substitute compliance, so you either have to comply with the rules in one country or the other, but not both.

Mr. LAMALFA. Right. That sounds very sensible. Quickly, on compliance decisions between outcome-based and element approach. You mentioned that a little bit earlier as well. Can you elaborate just a little bit on why the outcome-based is the preferred approach?

Mr. O'MALIA. Well, let's take, for example, end-user, the definition of *end-user* in the U.S. has one definition and *end-user* in Europe has another definition. If you look at that and you try to do it on an equivalent basis, you are going to come up with a different outcome. You are not going to say those are not equivalent end-users. Pension funds, for example, are end-users in Europe but they are not here. So applying those rules, if you go at a very granular level, you are going to find some differences, and you can never find equivalency, you can never trust the other regime. And, therefore, the industry is left compliant with two sets of rules, which is exactly where we are on trade execution, exactly where we are on data reporting.

Mr. LAMALFA. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. We are going to get a second round of questioning. I am going to recognize Mr. Scott from Georgia first in that second round.

Mr. DAVID SCOTT of Georgia. Yes, thank you. I want to continue my first line of questioning, and to pick up on my colleague that just spoke on the other side, concerning the cross-border, and specifically this situation with the EU.

And I want to ask you all, is this putting our American businesses at a competitive disadvantage right now? That is what I want to hear. If you are a clearinghouse, if you are someone like ICE, the IntercontinentalExchange, if you are a CME, if you are a farmer, if you are a manufacturer, if you are an American risk manager, hedge manager, does this uncertainty at this moment in time, is this putting our American businesses at a disadvantage in the global markets?

Mr. O'MALIA. That is the same question the regulators in Europe or in Asia ask their constituents as well. Everybody wants to make sure that they protect their industry, they protect their people, they protect their markets, and I understand that. And that does create tension at the beginning of any conversation on equivalence. And they want to make sure that they have thought of everything. And we want to make sure that the outcomes achieve the same thing, because you do not want to have an unlevel playing field that tips one way or another.

Now, we don't have all the rules completed in Europe yet, so it is tough to tell on some of these competitive issues around trade execution. We did get to an outcome, or we have a draft outcome on CCP recognition that would make the jurisdictions equivalent.

Mr. DAVID SCOTT of Georgia. But if you, Mr. O'Malia, if you had to answer my question right now, would you say is this uncertainty, this delay year after year, month after month, is it putting American businesses at a competitive disadvantage?

Mr. O'MALIA. I would answer yes, I mean because uncertainty always leads people to do less of something in order to account for that uncertainty. So the outcome, if the United States was not recognized by Europe, and it looks like we are going to be, there is a transition here, but many of the European banks that are members of the CME, of ICE, could not participate in those markets. It would be the capital punitive damages would be so high that they would just have to be out of the business. And again, what does that do? Well, that shrinks choices for customers that can't access markets through those clearing members, it is going to necessarily raise costs because of that. And so yes, it is going to cause an immediate impact.

Mr. DAVID SCOTT of Georgia. Right. And do you feel that it would be helpful in any way for us here in Congress to begin to put on the table and discuss any retaliatory means that might be necessary, whether you take them or not, but there ought to come a time when we need to stand up for our American businesses and say enough of this. We don't deserve this level of disrespect for our American businesses. Is there something, a message that we can send here in Congress to let them know that this has to be straightened out, it is unfair to our businesses?

Mr. O'MALIA. Well, your oversight responsibilities on this Committee have been helpful. You have talked about this issue in several hearings and that has gotten Chairman Massad leverage in these negotiations. But, the rest of the government is also important. The Treasury Department represents the United States in these types of negotiations. So your oversight responsibilities have helped to break this logjam, yes.

Mr. DAVID SCOTT of Georgia. Yes. I wanted to get to Mr. Deas as well in my last minute here, Mr. Deas, because if I remember in your testimony, you really hit on this competitive disadvantage. What say you about this?

Mr. DEAS. Well, thank you, Representative Scott. It is an important issue, and I can tell you that, just to bring it home, if we are competing against European companies whose regulators have exempted derivatives they enter into from higher capital requirements, then we as American companies are going to bear a higher cost for hedging the risk inherent in our business activity. And we have estimated that the difference here could be ten or 15 percent of the hedging costs.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. DEAS. And we would have to either absorb that cost or pass it through to the customer, putting us at a competitive disadvantage.

Mr. DAVID SCOTT of Georgia. Thank you very much, Mr. Chairman, I appreciate that because, especially Europe, because if it weren't for America, those folks in Europe would be speaking German right now.

The CHAIRMAN. More of them than already are. Yes, sir.

Thank you, Mr. Scott. I have a couple of questions, Mr. O'Malia, that I would like to follow up on. Are margin and capital rules complimentary? If so, should they be developed and implemented in tandem to minimize regulatory overreach?

Mr. O'MALIA. Right now, they are moving forward in tandem. And we ought to look at them for the cumulative impact that they are going to be having to the business. They happen to be coming in at the same time, and businesses are making very difficult decisions right now about how they deploy that capital.

The margin rules are separate, and that is going to have a big impact on the pricing of the OTC market. And we have yet to see kind of how it will be phased in and what the costs of that will be. That will be phased in over the next 4 years. But, now is the time to ask ourselves a question about the cumulative impacts of these, and spot the problems before we create some of these problems that we have identified today.

The CHAIRMAN. You pretty much answered my next question. I am going to ask it anyway. You just answered it as no, maybe in a little longer manner, but the question is, is that how the CFTC and the Prudential Regulators approach their respective rulemakings, ensuring that the capital regulations took into consideration the risk-producing effects of the margin requirements?

Mr. O'MALIA. We would obviously like to see the CFTC get their cross-border rules out quickly. That has been a big holdup. But by and large, the margin rules on a global basis are fairly consistent.

The CHAIRMAN. Has the Basel Committee, the Financial Stability Oversight Council, or any other body, undertaken a review of the potential cumulative impact of the various margin and capital requirements to ensure that those regulations are not unduly duplicative or overburdening the markets and their participants?

Mr. O'MALIA. Not that I am aware of.

The CHAIRMAN. Thank you, gentlemen, for being here. And the chair now recognizes the gentleman from Illinois for 5 minutes.

Mr. DAVIS. Thank you, Mr. Chairman.

Mr. Deas, quickly, I have a question for you.

Mr. DEAS. Yes, sir.

Mr. DAVIS. In your testimony, you comment that requiring dealing counterparties provide required stable funding for 20 percent of the negative replacement cost of derivative liabilities before deducting the variation margin posted is a clear example of the direct burdens that would affect end-users' ability to efficiently mitigate risk. Can you elaborate, since we talked about end-users a lot in this hearing, can you elaborate how this requirement directly impacts them?

Mr. DEAS. Congressman, I will be very happy to. Thank you for that question.

Mr. DAVIS. Thank you.

Mr. DEAS. Well, end-users deal with these banking institutions as derivate counterparties who are represented by, in some cases, over 200,000 employees. And the only way those employees act, or are directed by the management of the bank, is to price their derivative transactions, as an example, on the incremental cost. So the way it would work in this regard, the assessment of the market-to-market risk of an uncleared derivative would generate a funding requirement that has to be held in reserves equal to 20 percent of that exposure, and according to the net stable funding requirements, they have to hold 50 to 85 percent of that funding in long-term funding, either equity the bank has issued or long-term preferred stock, or long-term debt that they have issued, the cost of which has to be passed on to end-users. And we estimate that the effect of that is to increase the hedging cost by ten to 15 percent.

Mr. DAVIS. Ten to 15 percent?

Mr. DEAS. Yes, sir.

Mr. DAVIS. Much higher than what we heard in some of the testimony earlier today.

Mr. DEAS. Yes, sir.

Mr. DAVIS. Thank you. Mr. Lukken, we have had some discussion on, and you mentioned in your oral statement that other jurisdictions overseas are in the process of implementing the leverage ratio standards based on the Basel leverage ratio. How far along are the EU, Japan, and Switzerland in implementing these new standards based on Basel?

Mr. LUKKEN. Well, they are in the midst of—Basel III was implemented in 2010, but there are revisions that are out for comment right now. And, in fact, they have talked about the leverage ratio in that consultation, and they are asking for data on whether that should be fixed.

Europe has taken a different direction on this. Mark Carney, who is the Governor of the Bank of England, has come out with the same concerns that I am talking about today, which is why are we taxing clearing in this capital regime. And so the Europeans are thinking about going their own direction. So if, indeed, Basel decides not to recognize margin in these capital provisions, then Europe may decide to legislate its way out and just not implement the leverage ratio to tax clearing. That would be very harmful for the markets. We are trying to have internationally coordinated standards here through the Basel Committee, and if Europe is going its own way and the U.S. is punitively taxing clearing, that will end up harming U.S. businesses in the long-term.

So there is a process and this is happening over the next several years, but major decisions on this are being made for the next several months, and so today's hearing is very relevant and timely in that regard.

Mr. DAVIS. Okay, and take it a little bit further. Can you state for the Committee, you believe, or don't you, that this may cause problems for banks that obviously fall under multiple jurisdictions?

Mr. LUKKEN. Absolutely. This is an international issue, but international regulators have differences of opinion on this. And so, the fact that there is a disagreement between the market regulator, the CFTC on this, and the Prudential Regulators here in the United States, that may have international consequences on how this standard is put into place internationally.

Mr. DAVIS. So we have seen that Members of the European Parliament, Kay Swinburne, a Welsh Member of the European Parliament, has brought up this idea of the EU fixing unilaterally the leverage ratio, even if other jurisdictions like the U.S. are in opposition. Now, I mean do you foresee such an effort there, or do you think, as you just mentioned before, that there might be a better compromise through other means?

Mr. LUKKEN. Well, our hope is that this works its way through the Basel process and there is a satisfactory resolution, but you have Members like Kay Swinburne, Markus Ferber, who I met with last week, as a Member of the Parliament in Europe, Jonathan Hill, the European Commissioner that covers these markets. I mentioned Mark Carney. So there is growing consensus in Europe. I can't predict what their legislature will do there, but there is growing consensus that this is a problem that needs to be fixed one way or another.

Mr. DAVIS. So you would like the agencies to fix it and keep the politicians out, right?

Mr. LUKKEN. Exactly. Like I said, this is simply measuring the actual economic exposure of banks. We are not asking for an exception. To me, this is just measuring it right. Let's measure what the actual risk is and then let's move on.

Mr. DAVIS. And keep the politicians out, just like here.

Mr. LUKKEN. Exactly.

Mr. DAVIS. Thank you.

Mr. LUKKEN. Yes.

The CHAIRMAN. Gentlemen, thank you for being here for this review of the impact of capital and margin requirements on end-users. Before we adjourn, I would like my Ranking Member, Mr. Scott, to make any closing remarks he has.

Mr. DAVID SCOTT of Georgia. Well, just very briefly, Mr. Chairman. This has been a very, very important hearing, and a very essential one. But I do hope a message has gone out from us Members in Congress, particularly on this cross-border thing. First, each of you recognize and articulated that this failure to deal with equivalency situation with the EU definitely puts the American businesses, manufacturers, end-users, and all of those, clearinghouses, at a distinct competitive disadvantage. And it is my hope, and the reason I stressed this is that I served on this Committee, Ranking Member, mostly on the Financial Services Committee but I am also a Member of the NATO Parliamentary Assembly, and some of these same people I deal with also deal with the EU. And that is why I want a very strong message going out here today that we need to stop this foolishness with discriminating against American businesses, or else there will be retaliatory moves made.

The CHAIRMAN. Thank you, Mr. Scott.

Under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material and supplementary written responses from the witnesses to any questions posed by a Member.

This hearing of the Subcommittee on Commodity Exchanges, Energy, and Credit is adjourned.

[Whereupon, at 11:27 a.m., the Subcommittee was adjourned.]

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