SPEECHES & TESTIMONY

Joint Statement of Chairman Heath Tarbert and Commissioner Brian Quintenz in Support of Interagency Cooperation to Strengthen U.S. Financial Markets and Better Serve the Real Economy

September 16, 2019

We are pleased to support the interagency amendments to the Volcker Rule, which simplify the rule's application; provide objective, clear standards for prohibited and permissible activities; and tailor the rule's requirements to focus on entities with the most significant trading activity. The revisions ensure that banking entities are able to serve their clients effectively and provide the traditional banking services that underpin our nation's economic growth, without concern that such activity could implicate the Volcker Rule's prohibitions. The final rule highlights how cooperation among financial regulators can address the unintended consequences of prior regulations and ensure that capital formation and financial intermediation are not stifled by unnecessary regulatory complexity.

But more work remains to be done. It is critical that regulators continue to evaluate the efficacy of post-crisis reforms to ensure that they work in concert to support the vitality, resiliency, and health of the real economy. Just as the Commission worked productively and supportively with the banking regulators to adopt appropriate adjustments to the Volcker Rule, it is our hope and expectation that the banking regulators will continue to work with us to recalibrate certain capital requirements to ensure they are appropriate for derivatives transactions.

The banking regulators have recently proposed a rule to adopt the standardized approach for counterparty credit risk (SA-CCR) methodology for purposes of calculating risk-weighted assets under capital requirements. The proposal also incorporates a modified version of SA-CCR into a firm's supplementary leverage ratio (SLR) calculation. As proposed, the implementation of SA-CCR could have a profoundly negative impact on the derivatives markets generally, and particularly on America's energy producers and consumers—including farmers, ranchers, processors, manufacturers, retailers, and any business that relies on the transportation of physical goods.

With respect to the SLR calculation, our Commission has consistently advocated for adjustments that would allow clearing members to take into account segregated initial margin received from clients.[1] Reworking the SLR formulation is critical to ensuring that firms are not disincentivized from offering clearing services to end users and other clients. It is also critical to ensuring that central counterparties—some of which are systemically important—not be deterred from increasing margin requirements when appropriate for their continued safety and soundness.

Recognizing these concerns, the Basel Committee on Banking Supervision recently revised its recommended leverage ratio treatment for client cleared derivatives to include an offset for initial margin. We urge the banking regulators to move swiftly to revise our domestic regulatory framework consistent with the international standards. A margin offset would level the global playing field and, most importantly, avoid further clearing member consolidation and reduction of client clearing services in the United States. An increased number of clearing members would benefit the U.S. derivatives markets by offering greater choice to customers. Moreover, derivatives exposures would be allocated among a greater number of participants, which may reduce systemic risk within U.S. financial markets.

In its current form, the SA-CCR proposal arbitrarily treats all energy commodities the same, irrespective of their individual risk profiles. As a result, the proposal is likely to increase transaction costs and diminish market liquidity in the commodity derivatives markets. Although the Basel Committee did not provide transparency into its own decision-making process to assign supervisory factors to specific commodity asset classes, the Committee did distinguish between electricity and oil/gas commodities—assigning the latter a much lower supervisory factor compared to the charge for electricity contracts. In contrast, the SA-CCR proposal adopts an inefficient approach that would uniformly apply electricity's higher supervisory factor to the entire energy hedging set.

The end result would be nothing less than punitive treatment for oil and gas derivatives transactions. Indeed, commenters have noted that a bank's exposure calculations under SA-CCR with an end user counterparty could increase up to 460%.[2] Increased exposure calculations due to this mispricing of risk will result in higher capital charges that will likely be passed on to end users in the form of higher transaction pricing. This could burden everyday Americans with increased energy bills and higher prices for groceries and other consumer products. To avoid that outcome, we believe the supervisory factors for all types of commodities should be revisited to ensure they are appropriately calibrated to the actual risks of the underlying commodity and the maturity of the derivatives contract.

Similarly, in order to ensure that end users' exposures to bank counterparties are not over-inflated and that liquidity constraints do not preclude prudent risk management, we recommend that banking regulators consider recognizing relevant non-cash collateral arrangements under SA-CCR, when consistent with principles of safety and soundness. Alternative collateral arrangements are frequently used by banks in commodity derivatives transactions with end users to create "right way" risk and can be effective means of managing the credit risk of certain derivatives transactions. Allowing for the appropriate degree of recognition of these risk-reducing arrangements would increase the risk-sensitivity of SA-CCR and reduce the increased transaction costs likely to be borne by commercial end users.

As the final rule adopted by the Commission and our regulatory counterparts demonstrates, interagency cooperation over areas of joint jurisdiction can yield significant benefits and efficiencies for U.S. financial markets. We hope to continue this coordinated approach to promote robust, competitive U.S. derivatives markets that support the growth and well-being of American businesses. We believe the changes discussed above are necessary for ensuring that commercial firms are reliably able to access liquid, efficient derivatives markets to manage and hedge the risks of their core businesses. We also believe these changes will yield benefits and efficiencies for the real economy. They will help support our energy, industrial, and manufacturing sectors that are essential for the prosperity of American workers and families.

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[1] *See* Letter re: Capital Adequacy: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts from Chairman J. Christopher Giancarlo, Commissioner Brian Quintenz, Commissioner Rostin Behnam, and Commissioner Dan Berkovitz to Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, Department of Treasury, Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, and Robert E. Feldman Executive Secretary, Federal Deposit Insurance Corporation (Feb. 15, 2019), available here. Commissioner Dawn D. Stump recused herself from the foregoing letter and from commenting on the proposal.

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