

September 7, 2018

Financial Stability Board
Derivatives Assessment Team

Re: Consultation on “Incentives to centrally clear over-the-counter (OTC) derivatives, a post-implementation evaluation of the effects of the G20 financial regulatory reforms”

Dear Members:

Chatham Financial Corp. (“Chatham”) appreciates the efforts of the Derivatives Assessment Team (“DAT”) and its Committees¹ to reassess the effects of G20 financial regulatory reform efforts relative to the goals thereof. Chatham shares the goals of reform, namely, to make derivatives markets safer and more transparent. At the same time, we believe reforms should not unduly burden market participants that use derivatives markets to reduce risk and who transact in quantities incapable of meaningfully contributing to systemic risk. With derivatives market reforms now substantially in effect globally, we believe the DAT’s efforts to assess the reforms and to consider their impacts is timely and valuable.

Chatham is the largest independent adviser and technology provider to derivatives end users, advising and providing services to more than 2,000 clients annually on interest rate, currency, and commodity hedging. We serve both financial end users – including regional and community banks – and non-financial end users touching virtually every segment of the economy, from transportation firms, to manufacturers, to real estate companies, to professional sports teams. We are a global firm with operations in the United States, Europe, Australia, and Asia. We assist clients with a wide variety of risk management functions, including risk analysis, execution, hedge accounting, aspects of regulatory compliance, and valuations.

We offer the following comments in response to the questions in the consultation.

Question #1: Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

Chatham shares the view that, in general, there are strong incentives for dealers and larger financial firms to centrally clear OTC derivatives. We agree that some categories of clients have a lower incentive to use central clearing, particularly end users whose activities do not generally implicate systemic risk concerns. We believe those parties whose derivatives activity has the greatest potential to impact systemic stability are currently subject to adequate and effective clearing incentives.

Question #2: Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report’s characterization of

¹ The Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures, the Financial Stability Board, and the International Organizations of Securities Commissions

distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

Chatham agrees with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear – especially reforms that created or increased bilateral margin and capital incentives. We also appreciate the consideration the report gives to how incentives vary for market participants of different sizes and with different types of portfolios (e.g., directional portfolios). We believe the questions raised by the report about the merits of applying these incentives uniformly to all financial entities are appropriate in light of the more limited systemic risk contribution of some financial entities.

Question #3: Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

Chatham believes that margin requirements for uncleared derivatives give a sufficient incentive to clear, particularly for the largest users of derivatives. This is because, for such entities, the higher initial margin requirements for uncleared swaps make it such that it is more capital efficient to transact in cleared swaps, which have lower initial margin requirements. We believe policy makers have appropriately reduced these incentives via initial margin thresholds for those that transact in smaller quantities. We believe policymakers could reasonably extend the principle on which such thresholds were established to variation margin – i.e., by establishing variation margin thresholds.

Question #4: The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

We believe the report provides a robust picture of the key factors driving incentives to centrally clear. While we agree that both regulatory and non-regulatory factors influence clearing incentives, we believe that regulatory factors dominate the analysis for most financial end users.

We would note that various jurisdictions have applied or considered applying special treatment for inter-affiliate transactions, whether specifically for the benefit of end users or more broadly for all market participants. We support regulatory policies that account for the distinct characteristics of inter-affiliate transactions and think policy makers should carefully consider whether regulatory incentives are appropriate for such transactions.

Question #5: Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

While we have not generally found liquidity in most uncleared products to be impaired as a result of post-crisis reforms, we have observed bid-offer efficiencies with respect to cleared products. However, we

believe caution is warranted in making firm conclusions on liquidity because the real test of liquidity comes during periods of significant stress where liquidity can vary unexpectedly and dramatically.

Question #6: There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

While we are interested to observe and further evaluate the potential of direct clearing, we are currently of the view that this will be of little or no benefit to the vast majority of financial or non-financial end-users, because it does not materially change the costs and benefits of clearing for them.

Question #7: Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

- a. Central clearing mandates (both in terms of product scope and entity scope)
- b. Minimum standards for margin requirements for uncleared derivatives
- c. Capital requirements for credit valuation adjustment (CVA) risk
- d. Capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM))
- e. G-SIB requirements
- f. The leverage ratio

As a service provider not directly subject to various of these requirements, we are not best positioned to assess each of these policies in detail. However, we generally agree with the report's assessments with respect to certain of these requirements, including central clearing mandates, minimum margin requirements, and capital requirements for CVA risk.

Question #8: Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

As a service provider that is not a clearing member, we are not best positioned to assess the impact of various policies on clearing service providers. However, as a party otherwise intimately engaged in the OTC derivatives markets, we generally agree with the report's characterisation.

Question #9: Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

Chatham is supportive of efforts to exclude initial margin from leverage ratio calculations in order to reflect the risk reducing nature of initial margin. We believe such efforts will reduce a cost impediment to clearing for some market participants and will eliminate what we understand to be a key disincentive to offering clearing services. We believe the benefits of such a policy would ultimately accrue to financial end users within the ambit of clearing mandates.

Question #10: Do you agree or disagree with the consultative report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:

- a. Accessing clearing arrangements
- b. Conducting trading and/or hedging activity given the restrictions imposed by client clearing service providers?

We share the view that it is difficult for smaller financial entities to access clearing arrangements due to the minimum fees associated with clearing and/or the more limited appetite clearing members have to undertake efforts to onboard smaller market participants. Additionally, the cost impediments associated with clearing generally make engaging a back-up clearing member impracticable, particularly with respect to smaller end users.

Question #11: Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

Chatham generally shares the view that clearing services are concentrated in a relatively small number of banks, and we have questions about the extent to which this may adversely affect the market in periods of market stress. As the number of clearing members – especially with respect to US interest rate markets – has declined since the passage of financial reforms, costs to end users have generally increased. For example, minimum fees – at one time as low as USD 60,000 per year for highly competitive service providers – increased to approximately twice that as a number of clearing members that offered their services at more aggressive prices exited the market.

Question #12: Do you agree or disagree with the report’s characterisation of the incentive effects created by up-front and ongoing fixed costs of:

- a. Using clearing services?
- b. Providing client clearing services?

Chatham shares the view that up-front and ongoing fixed costs associated with central clearing are a material burden for small market participants and/or those that transact in smaller quantities. These costs are a material disincentive for some parties with respect to clearing. We have discussed these issues in detail in public testimony² and in various publications³.

Question #13: In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding

² Relevant testimony includes, in each case, by Luke Zubrod: (1) U.S. House Agriculture Subcommittee Hearing to Review the Impact of the G20 Clearing and Trade Execution Requirements (June 14, 2016); (2) U.S. CFTC Market Risk Advisory Committee Meeting (April 25, 2017); (3) U.S. CFTC market Risk Advisory Committee (April 26, 2016), (4) U.S. Market Risk Advisory Committee (November 2, 2015)

³ Relevant articles includes, in each case, by Luke Zubrod: (1) Reuters Breakingviews, “Fuzzy Swaps” (July 25, 2014); (2) Treasury & Risk, “It’s Time for a New Chapter in Derivatives Reform” (November 28, 2016); (3) CFO.com, “Dodd-Frank Was Too Much - and Not Enough” (September 20, 2017)

the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

Clearing incentives exist for all market participants, albeit some more than others. Additionally, some market participants are simultaneously subject to disincentives. Whether the preponderance of incentives and disincentives favors clearing depends on an array of factors, including a firm's cost of capital, their access to liquidity, and their transaction volume. The key incentives to clear include bilateral margin requirements and higher transaction pricing on uncleared swaps that derives principally from capital requirements charged to banks.

Initial margin is the key incentive to clearing, but only to the extent that initial margin for uncleared swaps exceeds initial margin for cleared swaps. Thus, those that transact in very large quantities have the largest incentives to clear, and this seems appropriate in light of the systemic risk contribution of such parties.

End users also are subject to clearing incentives as a result of the capital charges applicable to their dealer counterparties, which capital charges are generally passed along to end users through transaction prices. A key disincentive for clearing is the cost of clearing. For smaller entities and/or those that transact in small quantities, a key component of this cost are the minimum fees charged by clearing members.

An implication of these dynamics, in our view, is that market efficiencies could be increased without compromising the resiliency of the markets. This could be done by narrowing the scope of clearing and bilateral margin requirements with a goal of focusing such requirements on the systemic core of the markets and affording greater flexibility for those parties – whether financial or non-financial – that make only limited contributions to systemic risk.

Question #14: Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

Regulation should not seek to create incentives for all financial firms to centrally clear OTC derivatives. Rather, regulation should focus on mitigating systemic risk in the markets as a whole, even while affording flexibility with respect to central clearing and bilateral margin requirements for the benefit of segments of the market where such requirements are burdensome and where their application is unnecessary for the mitigation of systemic risk. Notably, many financial end users transact in quantities that have little or no bearing on systemic risk. Even while the failure of such firms would not implicate a financial stability concern, their derivatives activity tends to strengthen the firms by eliminating or dampening risks (e.g., interest rate or currency risk) that otherwise might weaken the firms' finances. When required to clear and/or post margin, such firms often face unduly burdensome costs, including minimum fees charged by clearing members and that may be triggered by a firm's lower transaction volumes, or liquidity risks due the initial and variation margin requirements that attend clearing or bilateral margin requirements.

Certain national jurisdictions⁴ have recognized these burdens and have made or are making accommodation for smaller end users, including by setting notional-based thresholds below which a financial entity is not subject to clearing and/or margin requirements. Others⁵ have defined certain types of financial entities that are not subject to clearing and/or margin requirements. Still others⁶ have enacted long delays for certain types of financial entities. While each such exemption provides meaningful relief to affected market participants, it is our view that such accommodations do not compromise financial stability as a whole. This is largely because these entities tend to use derivatives in relatively small quantities and do so for the purpose of managing risk.

Further, we consider that capital incentives – particularly the CVA capital charge – increase costs for end-user risk management activities and have the effect of discouraging the use or increasing the cost of the bilateral OTC markets for such parties. Policy makers considered the lower systemic risk contribution of end users in crafting end-user exemptions from clearing and margin requirements, but did not uniformly carry the logic undergirding these exemptions through to the CVA capital charge. While the EU exempted end-user hedges from aspects of the CVA capital charge, other jurisdictions apply these charges under their capital requirements frameworks, increasing transaction costs for some end users. End users especially value the OTC derivatives markets, both due to the ability to customize credit arrangements to meet their needs and because of the ability to perfectly offset their hedged risks. In addition, the perfect offset generally translates to hedge accounting outcomes that are consistent with company objectives. Thus, we believe the CVA capital charge should, on a global basis, not apply to end-user hedging transactions and that this incentive should extend to encompass smaller financial end users in addition to non-financial end users.

It is most essential that capital, clearing, and margin requirements focus on large systemically significant users of derivatives, including with respect to entities that speculate with derivatives in systemically significant quantities. While the size of an entity's derivatives portfolio – whether as calculated by the level of risk of an entity's portfolio or via an imperfect proxy thereof such as net notional amount – is the most obvious means of determining where clearing incentives should apply, the nature of transaction activity – whether hedging or speculative – is another reasonable consideration when defining to whom such incentives ought to apply.

We thank you for considering these comments. If you would like to discuss these issues further, please contact Luke Zubrod (610-925-3136 or lzubrod@chathamfinancial.com).

Sincerely,



Luke Zubrod

⁴ Australia, Singapore, Canada, Japan, and the European Union

⁵ For example, the US has exempted certain smaller banks and Australia has exempted certain types of real estate entities.

⁶ For example, the European Union has enacted and extended delays for pension funds