Ref: CHG/5/H29
March 14, 2017

Chris Kirkpatrick
Secretary
Commodity Futures Trading Commission
1155 21st Street, NW, Washington, DC 20581

Re: Capital Requirements of Swap Dealers and Major Swap Participants (RIN 3038-AD54)

Dear Sir:

The Japanese Bankers Association (the JBA) is an association of 139 Japanese banks and 50 non-Japanese banks with operations in Japan. Several of its member banks have registered, directly or through nonbank subsidiaries of bank holding companies (BHCs), with the Commodity Futures Trading Commission (the Commission) as swap dealers. The JBA appreciates this opportunity to provide comments on the Commission's notice of proposed rulemaking on capital requirements for swap dealers and major swap participants (the Proposed Rule).[1]

In response to public comments on a prior version of the Proposed Rule, the Commission now proposes to offer swap dealers that are not subject to the capital rules of a prudential regulator (CFTC SDs) the flexibility to choose among three different regulatory capital regimes, one based on the capital regime for BHCs (the BHC Capital Option), another on the regime for functionally-regulated entities (i.e., futures commission merchants (FCMs), securities broker-dealers, and security-based swap dealers), and a third for predominately non-financial entities. The JBA strongly supports this flexible approach.[2]

In the comments below, the JBA recommends additional changes that it believes will minimize unnecessary regulatory duplication and burden in the application of capital and liquidity requirements to certain categories of CFTC SDs located outside of the United States and to CFTC SDs that select the BHC Capital Option. Moreover, the requirements of the Proposed Rule, if not modified, could have the effect of discouraging nonbanking entities from acting as swap dealers because in many respects the requirements are more stringent for CFTC SDs than those imposed on a swap dealer that is subject to the capital requirements of a prudential regulator (a PR SD).[3]

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[1] Capital Requirements of Swap Dealers and Major Swap Participants, 81 Fed. Reg. 91,252 (proposed Dec. 16, 2016).

[2] The JBA also strongly supports the express recognition in section 23.105(i)(4) and (p)(7) of the Proposed Rule that the Commission's confidentiality regulations in 17 C.F.R. pts. 145 and 147 will apply to all reports submitted by swap dealers.

[3] The term "prudential regulator" is defined in section 1a(39) of the CEA to mean the Board of Governors of the Federal Reserve System (Board); the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency.

The JBA's recommendations are summarized as follows:

1) The final regulation should confirm that it does not apply to PR SDs (which would include Japanese banks that are subject to the Board's foreign banking organization (FBO) regulatory framework);
2) Non-US CFTC SDs that are subject to home country capital standards that are consistent with the Basel III capital standards should be exempted from the substituted compliance approval process;
3) The third element of the BHC Capital Option exaggerates the size of the CFTC SD's risk and should be revised to recognize the mitigating effects of hedging, margining, and clearing;
4) The eight percent common equity Tier 1 capital (CET1) capital requirement should be reduced and tailored to be consistent with the capital requirements that apply to BHCs;
5) Public disclosure requirements for swap dealers should be tailored to be consistent with those that apply to FCMs;
6) A CFTC SD that is a subsidiary of a BHC should be able to rely on the risk management framework of its parent BHC for certain aspects of the Commission's capital and/or liquidity requirements; and
7) A staggered phase-in approach should be applied to the implementation of the Commission's capital and/or liquidity requirements.

Each of these recommendations is discussed further below

1. <u>Application of Capital and Liquidity Requirements to Japanese Bank Swap Dealers</u>

Under the bifurcated approach in section 4s(e) of the Commodity Exchange Act (CEA),[4] a PR SD is not subject to the Commission's capital requirements. Under this approach, a swap dealer that is a Japanese bank that is subject to the Board's FBO regulatory framework is a PR SD, and is therefore not subject to the Commission's capital (or liquidity) requirements.[5] For the sake of clarity, we recommend that the Commission specifically state in the final regulation that PR SDs, including foreign banks that are subject to the Board's FBO regulatory framework, are not subject to the Commission's final regulations.[6]

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[4] 7 U.S.C. § 6s(e).
[5] Under section 1a(39) of the CEA, the definition of PR SD includes a BHC (which includes a foreign bank that owns a US bank subsidiary) and a foreign bank that is treated as a BHC under 12 U.S.C. § 3106(a) (because it has a US branch, agency, or commercial lending subsidiary). Such foreign banks are included in the Board's swap dealer capital rule as FBOs. Japanese banks that are PR SDs are subject to the Basel III capital requirements as implemented under Japanese law. The Board has concluded that Japanese capital requirements are consistent with (and even "equivalent to") the Basel III capital standards applied to US BHCs. *Sumitomo Mitsui Financial Group*, 101 Fed. Res. Bull. 47 (Feb. 20, 2015); *The Shizuoka Bank, Ltd.*, 94 Fed. Res. Bull. C119 (Nov. 1, 2008).
[6] If the Commission's capital and liquidity requirements were applied to Japanese banks that are PR SDs, they would be subjected to two capital and liquidity regulatory regimes (Basel III and the Commission's final regulations), while US BHCs would be subject solely to the requirements of their prudential regulator, the Board.

2. Applying Substituted Compliance Standards to Non-US CFTC SDs

The Proposed Rule provides for substituted compliance by non-US CFTC SDs. The JBA respectfully requests that the Commission exempt non-US CFTC SDs from the substituted compliance approval process in cases where those swap dealers are subject to capital standards in their home countries that the Board has determined in the context of foreign banking organizations to be consistent with the Basel III standards, such as Japan. While such non-US CFTC SDs would not have direct or indirect banking operations in the United States, they are regulated by their home country in the same manner as non-US PR SDs. No purpose would be served in requiring such non-US CFTC SDs to comply with a separate and potentially burdensome process to obtain approval for substituted compliance for capital purposes. This is particularly true when the application of the Basel III standards in the jurisdiction is already the case and has been vetted by the Board in its supervision of FBOs based in the jurisdiction as detailed above in Section 1 of this comment letter.[7]

3. Computation of Minimum Capital Requirements for Uncleared Swaps and Security-Based Swaps

Section 23.101(a)(i) of the Proposed Rule provides that a CFTC SD selecting the BHC Capital Option must comply with the highest capital requirement computed under four tests. The test in subsection (C) requires that the CFTC SD maintain CET1 capital (as defined in the Board's regulations) equal to at least eight percent of the sum of a CFTC SD's aggregate initial margin amount for its positions in futures, cleared swaps, uncleared swaps, cleared security-based swaps, and uncleared security-based swaps (the Eight Percent Rule), as calculated on a counterparty-by-counterparty basis. The JBA believes that this approach would exaggerate the actual risk of the CFTC SD's transactions, and thus would put CFTC SDs at a competitive disadvantage to PR SDs. Additionally, if not modified, this approach would impose an excessive cost on CFTC SDs that could lead to reduced market liquidity. The JBA recommends that the approach in the Proposed Rule be changed to measure capital against the sum of the separately calculated uncleared swaps and cleared derivatives transactions.

The JBA believes the Eight Percent Rule exaggerates the actual risk based on the following considerations. First of all, it does not appropriately take into account that hedged and hedging transactions are, by definition, not subject to the same market risk as an initial unhedged transaction. Thus, assuming a well-hedged portfolio, even if all counterparties defaulted, those that had due from positions on one side of the market would cancel out those with due to positions on the other side of the market. By including both sides of the market, the Eight Percent Rule would have the effect of actually discouraging portfolio risk management because hedging transactions would require the maintenance of additional capital. It also seems to cut against the regulatory policy in the Volcker Rule that SDs acting as market makers hedge certain risks.

Second, this approach would not recognize that segregated margin effectively reduces credit risk. We note that the Commission has taken the position in other contexts that margin

[7] *Supra* note 5.

should be recognized in setting capital requirements.[8] Third, the Eight Percent Rule is inconsistent with the Commission's efforts to promote portfolio margining because the capital would be based on the gross initial margin amount associated with each counterparty, not the actual net risk that counterparty poses to the CFTC SD.[9] Finally, by including proprietary positions in futures, cleared swaps, and cleared security-based swaps, this approach would require more capital to be held against clearing organization credit exposure than is required for a bank in connection with its credit exposure to a qualifying central counterparty.[10]

4. Application of an Eight Percent CET1 Capital Requirement

The Proposed Rule would require CFTC SDs to maintain a minimum eight percent capital ratio consisting entirely of CET1 capital. As the Commission notes, this requirement is different from that imposed on BHCs, for which the minimum CET1 ratio is 4.5 percent, the minimum Tier 1 ratio (which can be satisfied with a combination of CET1 and Tier 1 capital) is six percent, and the total capital ratio is eight percent (which can be satisfied with a combination of CET1, Tier 1, and Tier 2 capital).[11] The Commission notes that it has not imposed various capital add-ons, such as the capital conservation buffer and countercyclical capital buffer. However, we cannot find in the Proposed Rule any justification for the assertion that the proposed eight percent CET1 requirement is comparable to the multi-tiered capital requirements applied to BHCs. Further, based on our own review, we found that many PR SDs would not appear to be required to meet the equivalent of an eight percent CET1 requirement.[12] We are concerned that this requirement would make it difficult for CFTC SDs to compete against PR SDs, and more generally, would deviate from the more tailored risk-based approach taken by the prudential regulators in their multi-tiered regulatory capital rules. At least in the case of those CFTC SDs that are owned by BHCs, we recommend that the Commission require that the capital elements be the same as those that apply to the consolidated BHC.

5. Disclosure Requirements

Section 23.105(i) and (p)(7) of the Proposed Rule provides that certain data should be made publicly available. The Commission states that this requirement is based on the disclosure requirements for FCMs. However, the information to be disclosed by swap dealers is broader than that required of FCMs. We recommend that the Commission modify the requirements to

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[8] For example, with respect to the Basel Committee setting of its supplemental leverage ratio. *See* Keynote Address by Chairman Massad before the Institute of International Bankers, Mar. 2, 2015.
[9] *See* Statement of Support by Chairman Gensler, Jan. 14, 2013.
[10] *See* 12 C.F.R. § 217.35(b)(3).
[11] *See* 12 C.F.R. §§ 217.2, 217.10(a).
[12] A US BHC is required to satisfy a 4.5 percent minimum CET1 capital requirement. To avoid restrictions on capital distributions and bonus payments, a US BHC will also be required to maintain an additional 2.5 percent of CET1 capital as a capital conservation buffer when that requirement is fully implemented in 2019, raising the effective CET1 minimum to seven percent. Additionally, to avoid restrictions on capital distributions and bonus payments, a US BHC that is a global systemically-important bank (G-SIB) may be required to maintain an additional amount of CET1 capital ranging from one to 4.5 percent. Even accounting for the effects of the capital conservation buffer and G-SIB surcharge, six of the 14 US banking groups with at least one swap dealer will be required to satisfy a minimum CET1 capital requirement that is less than eight percent. These calculations do not take into effect the Comprehensive Capital Analysis and Review, which may increase an institution's capital requirements on a case-by-case basis reflecting any specific concerns identified by the prudential regulators.

ensure that the scope of disclosure for swap dealers is not broader than the requirements applicable to FCMs.

Specifically, under section 23.105(i) and (p)(7) of the Proposed Rule, every swap dealer would be required to post its unaudited statement of financial condition on its website on a quarterly basis and its audited statement of financial condition on its website on an annual basis. In contrast, under 17 C.F.R. § 1.55(o)(1)(v), an FCM is only required to post its audited statement of financial condition on its website on an annual basis. We recommend that the Proposed Rule be revised to conform to the existing FCM requirement.

Further, under Section 23.105(i)(3) and (p)(7) of the Proposed Rule, every swap dealer would be required to post relevant information on its website within ten business days of the filing deadline specified in section 23.105(e), (d), and (p)(2). The corresponding regulation for FCMs, 17 C.F.R. § 1.55(o), does not impose a similar timing requirement, and the National Futures Association appears to have interpreted that regulation to mean that an FCM must disclose relevant information on its website "annually and as needed."[13] Accordingly, we recommend that the Proposed Rule be revised to conform to the FCM regulation by striking the ten business day requirement in its entirety.

6. Additional Comments Concerning CFTC SDs that are Subsidiaries of BHCs

First, section 23.102(d) of the Proposed Rule provides that the Commission may approve the CFTC SD's use of internal models to determine credit risk and market risk capital charges. In the case of a CFTC SD that is a subsidiary of a BHC, we recommend that the Commission clarify that this would include automatic approval of the BHC's internal model that has been approved by the Board. There seems to be no purpose served by requiring the CFTC SD subsidiary to use an internal model separate from that used by the BHC for the consolidated group or to seek separate approval for a model that has already been approved for use by the parent BHC.

Second, section (j)(1)(iii) of Appendix A of the Proposed Rule requires that the CFTC SD maintain policies and procedures that describe how it determines the period of significant financial stress that it uses to calculate its stressed value-at-risk (VaR) measure. With respect to a CFTC SD subsidiary of a BHC, we assume that this can be the same period that the BHC establishes. Since the BHC consolidates the CFTC SD's exposures, it would not make sense for the subsidiary to have a separate period or policy. We request that the Commission confirm that the policy and period adopted at the BHC level can meet the requirements.

Third, Appendix A of the Proposed Rule requires that a CFTC SD that wishes to use internal models to measure credit risk or market risk must include a counterparty concentration charge and portfolio concentration charge in the credit risk model and a concentration charge in specific components of the market risk model. This treatment differs from the prudential regulators' rules, which require the inclusion of concentration charges solely with respect to components of internal models used to measure market risk. To avoid placing CFTC SDs at a competitive disadvantage to PR SDs, the JBA requests that the Commission modify the proposal

[13] NFA, NFA REGULATORY REQUIREMENTS FOR FCM, IBS, CPOS, AND CTAS 16 (Feb. 2016).

so that CFTC SDs would not be required to include a counterparty concentration charge or portfolio concentration charge in internal models that are used to measure credit risk.

Fourth, section 23.105(c)(2) of the Proposed Rule requires that a CFTC SD must notify the Commission within 24 hours if its regulatory capital is less than 120 percent of its minimum regulatory capital requirement. This treatment differs from the notice requirements that apply to PR SDs, which give the PR SD up to 15 calendar days to notify its regulator of similar capital events.[14] To avoid placing CFTC SDs at a competitive disadvantage to PR SDs, the JBA requests that the Commission modify the proposal so that CFTC SDs would be subject to a 15 day notice requirement instead of a 24 hour notice requirement.

Fifth, section 23.103(c)(1) of the Proposed Rule provides that counterparty credit risk may be reduced by any margin that is maintained with a third-party custodian. The JBA recommends that the Commission also permit variation margin held by the CFTC SD to be included in the reduction of counterparty credit risk. Even if this variation margin is re-hypothecated to a third party, with respect to the original counterparty it remains collateral that the CFTC SD can access in case of a default. Accordingly, there appears to be no reason why such variation margin should be disadvantaged compared to that held by a third-party custodian.

Sixth, the Proposed Rule would apply liquidity requirements to CFTC SDs that are subsidiaries of a BHC, even though the BHC itself is required to manage liquidity across all of its subsidiaries. The JBA recommends that this requirement not apply to a CFTC SD that is a subsidiary of a BHC because it could be duplicative of and interfere with the management of the liquidity requirements at the BHC level.[15]

7. Phase-in Period

The Commission requested comment on whether it should phase-in the implementation of the final capital rule, including whether liquidity requirements should be phased-in after capital requirements. The JBA supports a phase-in period, including separate, staggered phase-in periods for the capital and liquidity requirements (if separate liquidity requirements are adopted), which is comparable to the approach used in other capital and liquidity requirements for financial institutions.[16] The JBA believes that a phase-in approach is necessary in light of the (i) complexity of financial institution and BHC group structures and holdings, including the long-term nature of many of their assets and liabilities, and (ii) economic and commercial infeasibility of rapidly altering those arrangements. CFTC SDs have not been subject to capital requirements

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[14] *See* 12 C.F.R. §§ 6.4(c)(1), 208.42(c)(1), 325.102(c)(1).

[15] We appreciate that under 12 C.F.R. pt. 249, a CFTC SD would be treated like a BHC, and therefore would be (i) exempt from the liquidity requirements if it has total assets of less than $50 billion dollars and (ii) allowed to use the modified liquidity coverage ratio at 12 C.F.R. § 249.61 if it has total assets of $50 billion or more, but does not satisfy the thresholds described in 12 C.F.R. § 249.1(b)(1). Nevertheless, for the reasons set forth in the text, we believe that the liquidity requirement should not apply at all to a CFTC SD that is a subsidiary of a BHC.

[16] *See, e.g.,* 81 Fed. Reg. 636, 703-04 (Jan. 6, 2016) (phase-in period for CFTC SD margin requirements); 80 Fed. Reg. 74,840, 74,898-99 (Nov. 30, 3015) (phase-in period for PR SD margin requirements); 79 Fed. Reg. 61,440, 61,538 (Oct. 10, 2014) (transition period for the bank liquidity requirements); 78 Fed. Reg. 62,018, 62,264-69 (Oct. 11, 2013) (phase-in and transition periods for the bank capital requirements); BCBS, Basel III Phase-in Arrangements (phase-in for bank capital and liquidity requirements).

at an entity level and it will take time for parent BHCs to re-arrange exposures and CET1 capital within the group to satisfy the new subsidiary-level capital and/or liquidity requirements. Additionally, CFTC SDs will need time to make operational changes, implement new systems, and allocate personnel to implement the capital and liquidity requirements.

Based on these considerations, the JBA recommends that the Commission adopt a phased implementation of the capital requirement under which a CFTC SD would be expected to maintain 100 percent of required capital no sooner than 24 months after the final regulation is issued and 100 percent of required liquidity no sooner than 36 months after the final regulation is issued.

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The JBA hopes that its comments will be helpful to the Commission as it considers final adoption of the proposal, and we would be pleased to answer questions or provide additional information on any of the issues raised in this letter.

Respectfully submitted,