AFR Americans for Financial Reform

May 15, 2017

Chris Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

**RE: Notice of Proposed Rulemaking, Capital Requirements for Swap Dealers and Major Swap Participants, RIN 3038-AD54**

Dear Mr. Kirkpatrick,

Americans for Financial Reform ("**AFR**") appreciates the opportunity to comment on the Commodity Futures Trading Commission ("**CFTC**" or "**Commission**")'s Supplemental Notice of Proposed Rulemaking on Capital Requirements for Swap Dealers and Major Swap Participants (the "**NPRM**" or **"Proposal**").[1]

In this Proposal, the CFTC lays out capital, liquidity, and disclosure requirements for CFTC-supervised entities transacting in swaps which are not directly subject to similar requirements from prudential regulators. These Covered Swap Entities (CSEs) include Swap Dealers (both stand-alone and non-bank subsidiaries of bank holding companies), Major Swap Participants, and Futures Commission Merchants (FCMs) conducting derivatives business. This proposal thus parallels the scope of a wide range of prudential requirements set out in multiple rules from banking regulators over the past six years.

We have a number of conceptual concerns with the proposal, and there are also some elements of the proposal we wish to support. But given the scope and complexity of the proposal, AFR may provide additional, more detailed comment after reviewing the responses to this proposal submitted from industry representatives.

***Concern Regarding Internal Models, and Support for the Margin-Based Capital Floor***

Our single greatest concern with the capital elements of the proposal is the potentially heavy reliance on the use of internal models at covered swaps entities. The reliance on internal models can permit regulated entities to manipulate risk controls to increase their own profits at the cost of increasing risks to the public. The post-financial crisis review of capital adequacy regulation at banks has revealed numerous errors and weaknesses in bank internal models, including direct

[1] Americans for Financial Reform is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/.

evidence that these models were manipulated to reduce capital charges.[2] These findings have led bank regulators to seek ways to reduce reliance on internal models and "floor" these models at standardized risk estimates.[3] By permitting covered swaps entities to calculate market risk solely using internal models, this proposal moves in the opposite direction. This is especially true since supervision of these internal models is optionally delegated to a self-regulatory organization, the National Futures Association (NFA).

The proposal does set out a fairly extensive list of conceptual requirements for the testing, approval, and maintenance of internal models, including regular back testing and the use of stressed VAR. These are positive elements of the proposal. However, as the Commission itself admits in the proposal, resource limitations at the CFTC will limit the Commission's capacity to engage in detailed supervision and oversight of these models. We are skeptical that the NFA will provide a proper supervisory backstop.

It is likely that the Commission will come under significant industry pressure to formally or informally relax the approval and supervision requirements on internal models, since resource limitations will mean that if the requirements in the Proposal are properly applied there may be significant wait times for internal model approval. It is also likely that the Commission will come under pressure to reduce its own standardized (non-internal models) estimates of derivatives capital requirements during the approval period. It is critical that the Commission resist these pressures. If resource limitations are preventing adequate supervision or approval of risk controls, the proper response is to increase resources, not loosen risk controls. This is the message that should be communicated to the industry as well.

A better approach is to have strong limitations or floors on the extent to which internal modelling could reduce loss absorbency. The Commission has taken some steps in this direction in the current Proposal. Most importantly, capital is apparently floored at 8 percent of total swap dealer margin, including margin below the initial margin threshold and margin that would be demanded of commercial end users. A minimum $20 million capital amount is included as well. While we are skeptical that these measures will fully counterbalance the risks of relying on internal models, we none the less strongly support these elements of the proposal. The inclusion of all margin, including margin that is not mandated under current initial margin requirements, is entirely appropriate, since such margin is still a measure of risk to the swaps entity.

We also strongly support the proposal that capital requirements must be satisfied by Common Equity Tier 1 capital. This more conservative capital requirement is appropriate given that the

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[2] Behn, Markus, Rainer Haselman, and Vikram Vig, "The Limits of Model-Based Regulation", European Central Bank Working Paper 1928, July 2016. Available at http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1928.en.pdf?17ae15d416e9a8ff8b16bbd3c746c471. Plosser, Matthew and Joao Santos, "Banks' Incentives and the Quality of Internal Risk Models", Federal Reserve Bank of New York, Staff Report 704, December, 2014. Available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr704.pdf

[3] See e.g. Tarullo, Daniel, "Rethinking the Aims of Prudential Regulation", Speech at the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014. Available at https://www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm

current proposal does not contain all the add-ons and supervisory safeguards that are present in the prudential regulatory framework.

***Substituted Compliance Requirement for Non-US Firms***

The proposal provides that non-U.S. domiciled firms can rely on the capital and reporting requirements of their foreign jurisdiction so long as the CFTC has made a substituted compliance determination that such foreign rules are comparable to US rules. We strongly support substituted compliance and the comparability requirement in this context, as the U.S. has consistently exceeded Basel minimum capital and liquidity requirements. Given the determination by U.S. prudential regulators that Basel minimums were not adequate, it is particularly crucial that the Commission uphold U.S. standards in these areas. This will require a careful and rigorous substituted compliance process.

However, we also recommend that the Commission simply require swap dealers that are part of a U.S. Bank Holding Company to comply with U.S. rules, without the option of a substituted compliance determination. Given that the consolidated holding company will have to comply with U.S. capital and liquidity rules in any case, the motivation for instead complying with foreign rules at the subsidiary level is unclear at best, and may be related to regulatory arbitrage.

***Liquid Assets Vs Tangible Net Worth***

We believe it is crucial that the Commission require that loss absorbency requirements for financial firms using a Net Liquid Assets capital approach be met with assets that are actually liquid. We are highly skeptical that an approach based on tangible net worth or accounting value will function properly in a time of financial stress. Counterparties will not be reassured if a firm needs to sell highly illiquid fixed assets or property in order to satisfy obligations.

The Commission correctly proposes a liquid asset approach for most financial entities, but a tangible net worth approach is permitted for firms with less than 15% of their revenue from "financial activities" and for Major Swap Participants (MSPs). The justification for permitting the tangible net worth approach in these cases is that such firms may be non-financial entities which are not organized to hold large amounts of liquid financial resources.

This justification appears unfounded in the case of MSPs. While loopholes in the Commission's MSP definition have led to few if any MSPs being designated, if they were designated many would be likely to be insurance companies. Insurance companies are regulated financial entities which would certainly have the capacity to hold liquid assets. Given the Commission's failure to designate a significant number of MSPs, there is no justification for not simply making a case by case determination of whether an MSP is a financial entity. A blanket classification of MSPs as non-financial is inappropriate.

Permitting the use of the tangible net worth approach for non-financial entities could also be problematic if it extends to entities that engage in significant commodity derivatives trading but happen to be affiliated with a parent company which also engages in large amounts of non-

financial business. In general, there is no justification for permitting significant swaps entities or FCMs to avoid using liquid assets simply due to their affiliation with non-financial companies. There are several ways to address this issue:

- The non-financial entity exemption could be capped at some absolute level of swaps activity. Entities transacting more than a certain level of notional value should be required to hold liquid assets regardless of other activities in their parent company.

- Alternatively, the 15% test could be applied at the subsidiary level rather than the level of the parent company.

Thank you for the opportunity to comment on this Proposed Rule. If you have questions, contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,
Americans for Financial Reform