Congress of the United States
Washington, DC 20515

The Honorable Jacob L. Lew
Chairperson
Financial Stability Oversight Council
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

November 5, 2015

Dear Secretary Lew:

As Members committed to ensuring a well regulated, safe, and efficient financial system, we write to express concern over the recent Basel III leverage ratio as it is applied to certain derivative clearing services. Specifically, we have concerns that the Basel III leverage ratio has failed to properly consider the exposure-reducing effect of segregated customer margin provided to a banking organization for the limited purpose of facilitating derivatives clearing services on behalf of customers.

When conducting derivatives clearing services, a bank acts as a clearing agent on behalf of a client seeking to enter into a cleared derivatives transaction. As a member of the clearinghouse, the bank guarantees the customer's trade and in doing so requires the customer to post cash or other highly liquid assets as margin. By its very nature, the customer margin received by the bank-affiliated clearing agent lessens the bank's exposure. The initial margin is there to absorb first losses ahead of the bank's guarantee of the cleared transaction to the clearinghouse.

Under the Commodity Exchange Act, this highly liquid margin must be legally segregated from the bank's assets so that it is always available to pay any debt owed by the customer to the clearinghouse ***before*** the bank must make good on its guarantee.[1] In this context, the Basel III leverage ratio appropriately recognizes the exposure created by the guarantee as an ***off***-balance sheet exposure, but it then fails to recognize the segregated liquid margin posted by the customer as reducing that exposure.

We believe the Financial Stability Oversight Council (FSOC) should thoroughly examine the treatment of the exposure reducing customer margin and facilitate a coordinated approach to address this apparent inconsistency between existing market regulations, new leverage ratio application, and the goal of increasing the transparency and efficiency of derivatives trading. Should the FSOC confirm that the segregated liquid margin is indeed safe and segregated from the banks' own funds and unable to be re-hypothecated for other uses, we believe that the current

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1 *See* CFTC Chairman Timothy Massad, Testimony before the U.S. House Committee on Agriculture (Feb. 12, 2015).

drafting of the Basel III leverage ratio does not correctly reflect the proper capital requirements for a client clearing business.

Pursuant to its findings, we request that the FSOC and the U.S. members of the Basel Committee on Banking Supervision support any necessary fixes to the new off-balance sheet component of the Basel III leverage ratio to recognize the exposure-reducing effect of segregated customer margin for cleared derivatives.

Customer clearing business is a lower-exposure, lower-return activity -- precisely because banks collect margin specifically dedicated to reducing their exposures. Without action by the Basel Committee to recognize the exposure-reducing effect of this margin, we fear that capital charges will be needlessly high, and many banks will consider limiting or discontinuing their customer-facing clearing businesses, thereby further consolidating an already small pool of clearing members in the market.

Moreover, we are concerned that concentration of clearing members will increase systemic risk during times of market turmoil, when needlessly high leverage capital constraints could impair a clearing member's ability to take on new customers or purchase a portfolio of derivatives from a distressed clearing member. The result of this reduced portability of customer positions will be mass customer liquidations that will exacerbate volatility during times of market distress and, potentially lead to additional defaults. Furthermore, consolidation among clearing members will potentially leave end-users with fewer choices for customer clearing services and limited access to the risk mitigation benefits of central clearing.

To be clear, we support an effective leverage ratio that ensures banking organizations are well capitalized commensurate with their economic exposures. However, with regard to customer margin for cleared derivatives, capital rules must be designed to accurately measure the actual economic exposure of the bank. Otherwise, these rules could have the unintended effect of jeopardizing recent efforts to improve our financial system through increased derivatives clearing and systemic risk mitigation. Ironically, only five years after the Dodd-Frank Wall Street Reform and Consumer Protection Act sought to bring more derivatives into the clearing regime, end-users may find it more difficult to use this tool to hedge their risks in a safe, transparent manner and the resulting concentration of clearing members will lead to increased risks to financial stability – risks that the FSOC is tasked with identifying and mitigating.

We therefore call upon you to address these issues by supporting the recognition of the exposure-reducing effect of segregated margin in the context of the off-balance sheet component of the Basel III leverage ratio. To do otherwise would be at odds with existing market regulations and systemic risk reduction objectives that the FSOC is expected to promote.

Sincerely,

John C. Carney

John C. Carney Jr.
Member of Congress

Randy Neugebauer

Randy Neugebauer
Member of Congress

Frank D. Lucas
Member of Congress

Bill Foster
Member of Congress

cc: Janet L. Yellen, Chairman of the Board of Governors of the Federal Reserve System
Thomas J. Curry, Comptroller of the Currency
Richard Cordray, Director of the Bureau of Consumer Financial Protection
Mary Jo White, Chairman of the Securities and Exchange Commission
Martin J. Gruenberg, Chairperson of the Federal Deposit Insurance Corporation
Timothy G. Massad, Chairperson of the Commodity Futures Trading Commission
Melvin L. Watt, Director of the Federal Housing Finance Agency
Debbie Matz, Chairman of the National Credit Union Administration
S. Roy Woodall, Jr., Independent Member Financial Stability Oversight Council