



July 7, 2011

Mr. David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581

Dear Mr. Stawick:

The Futures Industry Association (the “**FIA**”)<sup>1</sup>, the International Swaps and Derivatives Association (“**ISDA**”)<sup>2</sup> and the Securities Industry and Financial Markets Association<sup>3</sup> (“**SIFMA**” and, together with the FIA and ISDA, the “**Associations**”) appreciate the opportunity to provide the Commodity Futures Trading Commission (the “**Commission**”) with comments on the Commission’s capital requirement proposal (the “**Proposal**”)<sup>4</sup> for swap dealers and major swap participants (collectively, “**Swap Entities**”) as required under Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”). The Associations represent many financial institutions that will become Swap Entities under Dodd-Frank and that, as a result, will need to comply with the Commission’s capital rules.

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<sup>1</sup> The Futures Industry Association is the leading trade organization for the futures, options and OTC cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world’s largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearinghouses, our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions.

FIA’s core constituency consists of futures commission merchants, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA’s regular members, who act as the majority clearing members of the U.S. exchanges, handle more than 90% of the customer funds held for trading on U.S. futures exchanges.

<sup>2</sup> ISDA was chartered in 1985 and has over 800 member institutions from 54 countries on six continents. Our members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, visit [www.isda.org](http://www.isda.org).

<sup>3</sup> SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit [www.sifma.org](http://www.sifma.org).

<sup>4</sup> Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011) (the “**Release**”).

The Associations generally support those aspects of the Proposal that incorporate the Commission's existing regulations and the existing regulations of the Securities and Exchange Commission ("SEC") and the Federal Reserve Board ("FRB"). By doing so, the Commission avoids duplicative capital regulation and ensures consistent treatment across complex financial institutions. For example, the Proposal does not apply additional capital requirements to those entities already subject to capital requirements of a prudential regulator or to those entities that become systemically important financial institutions ("SIFIs") subject to capital regulation by the FRB. In addition, the application of bank holding company ("BHC") capital requirements for Swap Entities that are not prudentially regulated and are not futures commission merchants ("FCMs"), but are subsidiaries of BHCs, promotes consistent capital treatment across these complex institutions and avoids complicated entity restructuring for capital purposes.

However, in this letter the Associations encourage the Commission to reconsider certain elements of the Proposal, including the level of the minimum capital requirements, the conditions under which Swap Entities can use models to calculate capital requirements and the methodologies employed for capital calculations when models are not allowed.

### **Capital Requirements for Swap Entities that are Futures Commission Merchants**

The Associations generally support the incorporation of existing FCM capital and related requirements for those Swap Entities that are FCMs. In particular, the Associations support the amendments to Commission Rule 1.10,<sup>5</sup> which requires financial reporting by FCMs, Rule 1.12,<sup>6</sup> which requires FCMs to maintain minimum financial requirements and report to the Commission if funds decrease below predefined thresholds and Rule 1.16,<sup>7</sup> which sets the qualifications for and reports required by accountants, as they are substantially consistent with current rules. The Associations also support the proposed amendment to Rule 1.17(c)(6) that would continue to allow FCM Swap Entities that are SEC-registered broker-dealers to compute adjusted net capital using the SEC's "alternative net capital" method if permitted to do so by the SEC. The Associations believe that allowing these Swap Entities to continue to compute capital in this way best allows the financial holding companies of which they are a part to manage capital resources consistently across the entire institution.

Under the Commission's proposed amendments to Rule 1.17,<sup>8</sup> an FCM Swap Entity would be required to maintain adjusted net capital equal to the greatest of (1) \$20,000,000; (2) \$20,000,000, plus 5% of the FCM's liabilities to retail foreign exchange participants that exceed \$10,000,000 for FCMs that engage in off-exchange foreign currency transactions with non-eligible contract participants; (3) 8% of the risk margin of customer exchange-traded futures

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<sup>5</sup> See Release at 27,823 (amending 17 CFR 1.10, "Financial reports of futures commission merchants and introducing brokers").

<sup>6</sup> See Release at 27,824 (amending 17 CFR 1.12, "Maintenance of minimum financial requirements by futures commission merchants and introducing brokers").

<sup>7</sup> See Release at 27,824 (amending 17 CFR 1.16, "Qualifications and reports of accountants").

<sup>8</sup> See Release at 27,825 (amending 17 CFR 1.17, "Minimum financial requirements for futures commission merchants and introducing brokers").

positions and swap positions that are cleared by a clearing organization and carried by the FCM; (4) the amount of adjusted net capital required by a registered futures association of which the FCM is a member; and (5) for an FCM that also is registered as securities broker-dealer, the amount of net capital required by rules of the SEC. These capital requirements mirror those for non-Swap Entity FCMs, except that the minimum requirement is increased from \$1,000,000 to \$20,000,000. The amendments to Rule 1.17 also specify the haircuts applicable to certain types of financial assets, which appear to be largely based on SEC Rule 15c3-1(c)(2)(vi).<sup>9</sup> However, the Associations note that this paragraph of Rule 15c3-1 applies to fixed income and equity cash positions, as opposed to derivatives, and does not recognize hedging and risk management techniques used by Swap Entities. The Associations believe that this methodology may not be appropriate for swaps, which are often employed together with other financial instruments as part of a comprehensive regime that poses less risk to the Swap Entity than the individual instruments would in isolation. Thus, the Associations recommend that the Commission consider alternative approaches or amendments to the current Proposal, particularly in order to incorporate hedging and risk management techniques. To the extent this portion of the Proposal is incorporated into the final rule, the Associations suggest that the Commission reconsider other approaches once Swap Entities and the Commission better understand the use of swaps by Swap Entities post-Dodd-Frank.

As noted above, applying the existing FCM capital requirements to FCM Swap Entities will incorporate the current requirement that an FCM maintain adjusted net capital equal to at least eight percent of the total risk margin requirement for positions it carries.<sup>10</sup> The Associations believe that this approach is flawed for two reasons. First, capital requirements and initial margin requirements are not identical concepts. The former covers a longer time frame and captures a broader range of exposures. Nonetheless, they are complementary concepts in that both incorporate counterparty credit risk. Accordingly, the higher the initial margin requirement for a particular swap, the less regulatory capital a swap dealer should need to carry the client's position. The Associations believe that a rule structure equating capital and initial margin requirements would lead to allocations of dealer and client funding and capital to client portfolios in amounts disproportionately large in comparison to the risks of the relevant transactions. We have appended to this letter as Appendix A a presentation we provided to the SEC regarding the purposes of capital and margin and the interaction between the two.

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<sup>9</sup> 17 CFR 240.15c3-1(c)(2)(vi) ("Securities Haircuts" under "Net capital requirements for brokers or dealers").

<sup>10</sup> 17 CFR 1.17 (requiring that FCMs maintain adjusted net capital equal to or in excess of the greatest of a number of calculations, one of which is "[t]he futures commission merchant's risk-based capital requirement, computed as eight percent of the total risk margin requirement for positions carried by the futures commission merchant in customer accounts and noncustomer accounts").

Second, given that margin requirements for cleared<sup>11</sup> and uncleared<sup>12</sup> swaps have been proposed but not finalized, it is not yet certain how large this portion of the capital calculation would be. To the extent that the margin requirements result in high levels of required margin payments, this eight percent multiplier could result in high levels of capital requirements. As a result, we recommend that the Commission defer incorporating swaps into this margin multiplier for capital until after margin and capital requirements are finalized and the Commission and market participants have had the opportunity to evaluate margin levels and the interrelationship between swap margin and capital.

### **Capital Requirements for Non-FCM Swap Entities that are BHC Subsidiaries**

The Associations support the provision in the Proposal that would apply BHC-like capital requirements to Swap Entities that are nonbank, non-FCM subsidiaries of BHCs. Such Swap Entities would be required to have the greater of \$20,000,000 in Tier 1 capital or the minimum risk-based ratio requirements that would apply if the Swap Entity were a U.S. BHC, as provided under 12 CFR Part 225 and its appendices. Generally, these rules establish the required amount of regulatory capital in terms of a minimum ratio of qualifying total capital to weighted risk assets of 8%, of which at least 4% should be in the form of Tier 1 capital.<sup>13</sup> As stated above, the Associations support this provision of the Proposal as it allows consistent capital treatment throughout a BHC.<sup>14</sup>

However, since the definition of “prudential regulator” does not include comparable foreign regulators, it does not appear from the Proposal that subsidiaries of foreign financial holding companies would be allowed to calculate their capital requirements in this way. Instead, such subsidiaries appear to be subject to the fallback calculations for non-FCM, non-BHC subsidiary Swap Entities. We believe that the Commission should extend to these entities the ability to

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<sup>11</sup> See Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698 (Jan. 20, 2011) (proposing that, among other requirements, derivatives clearing organizations must set initial margin requirements at a level covering 99% of movements over a 1-day liquidation period for cleared swaps that are executed on a designated contract market and a 5-day liquidation period for all other cleared swaps). The margin requirements for cleared swaps will depend significantly on the rules adopted and methodologies used by derivatives clearing organizations.

<sup>12</sup> See Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (May 11, 2011) (describing the prudential regulators’ proposal for margin for uncleared swaps and security-based swaps for Swap Entities under their jurisdiction); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (Apr. 28, 2011) (describing the Commission’s proposal for margin for uncleared swaps for Swap Entities under its jurisdiction). Among other provisions, both proposals require that initial margin requirements be set at a level covering 99% of movements over a 10-day liquidation period for all other cleared swaps.

<sup>13</sup> Such a Swap Entity must also meet any capital requirements of a registered futures association of which it is a member. The National Futures Association is the only existing registered futures association and has not, to this point, proposed capital requirements for Swap Entities.

<sup>14</sup> The Associations do not believe, however, that Swap Entities that are subsidiaries of financial entities that are SIFIs or global SIFIs (“G-SIFIs”) should be subject to the additional capital surcharges that would apply to their parents as SIFIs or G-SIFIs. In addition, the Associations believe that Swap Entity subsidiaries of BHCs should be able to calculate their capital requirements using Basel II or (when implemented) Basel III approaches rather than looking to the greater of that capital requirement and Basel I, as required for BHCs under the Collins Amendment. If, as the Associations request below, this treatment is extended to foreign financial holding companies, we believe the same limits should apply to their Swap Entity subsidiaries.

calculate their capital using methods similar to other subsidiaries of the financial holding company. Without such an extension, subsidiaries of foreign financial holding companies would be at an unfair competitive disadvantage in facing multiple sets of capital requirements.

### **Capital Requirements for Non-FCM, Non-BHC Subsidiary Swap Entities**

The Commission proposes a minimum capital requirement of \$20,000,000 of tangible net equity for Swap Entities that are not FCMs or non-bank subsidiaries of BHCs.<sup>15</sup> Tangible net equity is defined as a Swap Entity's equity, as determined under U.S. generally accepted accounting principles, excluding goodwill and other intangible assets. Such equity would include illiquid assets, such as property, plants and equipment, that would not qualify as current assets under FCM adjusted net capital requirements. Also included would be the assets and liabilities of any subsidiary or affiliate that the Swap Entity guarantees, endorses or assumes directly or indirectly. The Swap Entity may consolidate such assets and liabilities for a subsidiary or affiliate that the Swap Entity controls or majority-owns, provided that it obtains an opinion of counsel stating, among other things, that the net asset value attributable to the Swap Entity from the subsidiary or affiliate could be distributed to the Swap Entity within 30 calendar days.

The Associations believe that, given the way in which tangible net equity is calculated, \$20,000,000 is an unrealistically low minimum for such Swap Entities when compared to the capital requirements applicable to other Swap Entities and in light of the level of risk associated with some swaps. As a result, the Associations suggest that the \$20,000,000 threshold be raised. In addition, the Associations understand that "tangible net capital" includes assets less liquid than those that FCMs can use for "adjusted net capital" to enable entities whose assets are largely illiquid, such as energy and commodity businesses, to operate as Swap Entities. Nonetheless, we believe that the stability of the swaps markets requires that the Commission ensure some level of liquidity of FCM capital. The Associations suggest that this could take the form of comprehensive liquidity risk assessment reporting requirements, which should require the entity to show that its liquidity is adequate to support its outstanding swaps. The Associations understand that the exact measure may differ based on the type of business the Swap Entity is engaged in.

In addition to the tangible net equity requirement, the Proposal adds a "market risk exposure requirement" and an "over-the-counter derivatives credit risk requirement." The market risk exposure requirement is meant to quantify the capital needed to protect against market movements in uncleared swaps and in the instruments the Swap Entity uses to hedge those swaps. The OTC derivatives credit risk requirement is meant to quantify the capital that Swap Entities must maintain to cover potential counterparty credit exposures for receivables arising from uncleared swap positions and from the instruments used to hedge those swaps. Major swap participants will need to count all swaps into which they enter in order to determine capital requirements, while for swap dealers, only swaps entered into as a part of swap dealing activity and instruments used to hedge those swaps are counted. We believe this dichotomy is consistent with the difference between the definition of "swap dealer," which only involves dealing activity,

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<sup>15</sup> See Release at 27,827 (proposed §§ 23.101(a)(1), (b)(1)). The capital requirements in the Proposal, including these, do not apply to Swap Entities with a prudential regulator (including banks) and those that are designated as SIFIs.

and “major swap participant,” which looks at the overall swap positions an entity carries in almost any capacity. We also believe that this dichotomy is appropriate for the different risks that swap dealers and major swap participants face.

### **Allowable Use of Capital Models**

The Associations support the Commission’s proposal to allow U.S. BHCs and their subsidiaries to use models approved by the FRB to calculate capital requirements. Similarly, the Associations support the Commission’s proposal to allow security-based swap dealers and major security-based swap participants (“**Security-Based Swap Entities**”) to use internal models subject to SEC assessment to calculate capital requirements. Based on our previous experience, particularly with the grid for securities haircuts in Rule 15c3-1(c)(2)(vi),<sup>16</sup> the Associations believe that model-based approaches to capital calculation are superior to grid-based approaches. We have appended to this letter as Appendix B a presentation we provided to the SEC regarding the relative benefits of models over grids for capital calculations.

Grid-based approaches lack a number of attributes of a sound capital methodology. First, grids are generally insufficiently risk sensitive as they assume risks can and should be identified and attributed by product instead of across products by risk type and cross-product hedging is generally not recognized. As a result, the amount of capital required is not necessarily proportional to an entity’s risk. In addition, it is difficult to make grids granular enough to reflect the different risks of products that may appear only slightly different but may have very different risk implications. Model-based approaches better recognize the total risk of an entity and may require either more or less capital than would a grid approach.

Second, a sound capital regime should be consistent, where possible, with business risk management processes. Model-based approaches, primarily consisting of value-at-risk (“**VaR**”) calculations, are well integrated into the risk management, compliance and business units of large global financial institutions and can be employed as part of a comprehensive, consistent risk management regime. Grid-based approaches, on the other hand, require duplicate processes and fail to leverage existing data, processes and systems. Grids are not part of risk management system for a number of reasons – importantly, unlike grids that evaluate capital charges on a product-by-product level, risk management systems evaluate capital requirements by business strategy. As a result, risk committees and senior management will not be able to incorporate the results of grid computations into comprehensive risk management policies and procedures on a Swap Entity-wide basis, as required elsewhere by the Commission.<sup>17</sup>

Third, recent experience has proven that it is hard to keep grids up-to-date to include innovative products and trading strategies. This will be a significant problem if grids are used in the swaps market, where innovation is rapid. It will be difficult to update grids to keep pace. If grids are not continually reviewed and updated, unintended consequences including regulatory arbitrage

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<sup>16</sup> 17 CFR 240.15c3-1(c)(2)(vi) (“Securities Haircuts” under “Net capital requirements for brokers or dealers”).

<sup>17</sup> See, e.g., Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71,397 (Nov. 23, 2010) (proposing risk management requirements for Swap Entities that include the creation of a risk management unit that would report directly to senior management).

may result. As an administrative matter, continual revision of rules that incorporate grids has been proven to be difficult.<sup>18</sup> As a result, creating and maintaining a grid may be as time-consuming as approving models, with far less benefit.

Finally, the use of models consistently drawn from the business unit's risk management process will promote consistency across entities under the jurisdiction of different regulators. This consideration is particularly important when designing a capital regime for Swap Entities, many of which will be Security-Based Swap Entities subject to the SEC's capital rules.

As a result, the Associations do not believe that the use of models should be as limited as proposed. The Associations support the use of models by subsidiaries of BHCs whose models are reviewed and assessed by the FRB and by Security-Based Swap Entities whose models are reviewed and subject to regular assessment by the SEC. The Associations believe that, as in the Commission's uncleared swap margin proposal, any Swap Entity should be allowed to use any model approved by any prudential regulator or the SEC.

The Associations also believe that the Commission should be prepared to directly review the models of those relatively limited number of Swap Entities prepared to use models that are not also BHC affiliates, Alternative Net Capital broker-dealers or OTC Derivatives Dealers under Rule 15a-1.<sup>19</sup> While the Associations recognize the difficulty of reviewing models, the Associations believe that the Commission should work towards this capability as part of its oversight of the swap markets.

In addition, the Associations believe that foreign nonbank Swap Entities that are subsidiaries of foreign financial holding companies should be allowed to use models approved by the foreign financial holding company's prudential regulator, which will ensure competitive equality and promote consistent capital treatment across complex institutions. The prudential regulator of a foreign entity is generally in the best position to assess whether a model is appropriate for the risks that the foreign entity faces. If the Commission allows all Swap Entities to use any model approved by a Prudential Regulator or the SEC, as requested above, we believe that similar treatment should apply to models approved by a comparable foreign prudential regulator.

### **Calculation of Market and Credit Risk Capital Charges Without Models**

Under the Proposal, Swap Entities who cannot or choose not to use models to calculate market and credit risk would apply a series of charges to its capital that are calculated largely based on approaches used in the Basel Accord.<sup>20</sup> We understand that such Swap Entities would first need to calculate a "market risk exposure requirement" for uncleared swaps that is based on the Basel standardized approach and is the sum of a general market risk charge and a specific risk charge, including for off-balance sheet position. These charges are determined using a detailed grid

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<sup>18</sup> The SEC's last update to Rule 15c3-1 was in 1998. *See* OTC Derivatives Dealers, 63 Fed. Reg. 59,362 (Nov. 3, 1998).

<sup>19</sup> 17 CFR 240.15a-1.

<sup>20</sup> *See* Release at 27,829 (proposed § 23.104).

structure depending on the product. Next, Swap Entities would be required to calculate an “OTC derivatives credit risk requirement,” equal to the sum of a “counterparty exposure charge” and a “counterparty concentration charge” for uncleared swaps and related hedge positions, minus collateral held by the Swap Entity from the counterparty and multiplied by a credit risk factor of 8%.

The members of the Associations have had little, if any, experience with the proposed methodologies and therefore are not in a position to offer complete substantive comment. In particular, to our knowledge, no large financial institution is using the standardized general risk approach. Given the very complex and nested calculations described above, the Associations believe that it would take a significant amount of time and effort to fully comprehend and analyze the approach. However, since the methodologies are largely grid-based, we believe the approach would suffer from the problems with capital grids described earlier in this letter.

### **Swap Valuation Disputes**

The Commission does not propose, but requests comment on whether it should adopt, a capital charge for swap valuation disputes.<sup>21</sup> The Associations do not believe that such a capital charge is necessary. Disputes arise when a counterparty is not willing to provide sufficient collateral to meet a Swap Entity’s mark. As a result, a Swap Entity faced with such a dispute has, according to its own calculations, unsecured credit exposure for which capital charges are required. Requiring an additional capital charge for a valuation dispute would therefore be tantamount to a duplicate capital requirement for a single economic exposure. In addition, as a practical matter, the Associations’ members do not understand how this additional charge would be calculated since the amount itself is in dispute.

### **Maintenance of Minimum Financial Requirements and Financial Recordkeeping and Reporting Requirements for Swap Entities**

The Proposal would impose new financial reporting, recordkeeping and notification requirements on Swap Entities.

FCM Swap Entities would be subject to existing FCM reporting requirements, to be amended to include a new Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer accounts in both the unaudited monthly form and the audited annual form. An FCM that is also registered as a Security-Based Swap Entity would have to file a notice with the Commission if it fails to maintain net capital above the minimum early warning level established by the SEC. FCMs would be further required to provide immediate notice by telephone, followed by immediate written confirmation, whenever any commodity futures, options, cleared swaps or other Commission-regulated account carried by the FCM is subject to a margin call that exceeds the FCM’s excess adjusted net capital, and whenever the amount of funds on deposit in accounts segregated for the benefit of the FCM’s swap customers is less than the amount the FCM is required to hold in such accounts. The Associations believe that this

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<sup>21</sup> Proposal at 27,818.

expansion of FCM reporting requirements is appropriate for those FCMs that become Swap Entities.

A Swap Entity subject to the capital requirements of a prudential regulator, or designated as a SIFI and under the FRB's oversight would be subject to financial reporting and recordkeeping requirements of its regulators. However, the Swap Entity would be required to provide the Commission with copies of its capital computations and supporting documentation upon request. In addition, such a Swap Entity would be required to provide the Commission with written notice if it is out of compliance with the minimum capital requirements established by its prudential regulator, or if it fails to maintain current books and records. The Associations believe that this deference to the prudential regulators, when combined with notification to the Commission, strikes the right balance between avoiding duplicative reporting and recordkeeping while still allowing the Commission to maintain appropriate oversight.

Other Swap Entities would be required to file monthly unaudited financial statements and annual audited financial statements with the Commission and with any registered futures association of which they are members. These statements would include a statement of financial condition, a statement of income or loss, a statement of cash flows and a statement of changes in stockholders', members', partners' or the sole proprietor's equity. The schedule would further disclose the firm's minimum required capital as of the end of the month or the end of its fiscal year. The Commission could further require a Swap Entity to file additional financial or operational information, and to repair or keep current ledgers or similar records which show or summarize each transaction affecting the Swap Entity's asset, liability, income, expense, and capital accounts. The Associations believe that these provisions are appropriate and help provide transparency into the swap markets.

If such a Swap Entity's tangible net equity falls below 110% of the minimum requirement, the Swap Entity must provide the Commission with written notice. If its tangible net equity falls below the minimum requirement, the Swap Entity must provide notice by telephone notice to the Commission followed by written notice. The rules also require written notice to be filed if the Swap Entity fails to maintain current books or records. The Associations believe that these provisions are appropriate and help provide regulators with information useful for oversight of Swap Entities.

### **Implementation Period**

While the Proposal does not specify an implementation period, the Associations believe that the 60 day minimum provided for by Dodd-Frank is insufficient for implementation of capital rules. Once capital rules are finalized, members of the Associations will have to carefully analyze the rules and understand their impact on entity business choices. Implementation will require substantial technology and operational work to collect information and calculate capital requirements. This work will require considerable lead time, especially in view of the numerous major changes to the Association members' business under Dodd-Frank and, as a result, the Associations believe that a significant implementation period is necessary to avoid disruption to the swaps markets.

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The Associations appreciate the opportunity to comment on the Proposal. Please feel free to contact the undersigned with any questions.

Respectfully submitted,



John M. Damgard  
President  
FIA



Robert G. Pickel  
Chief Executive Office  
ISDA



Kenneth E. Bentsen, Jr.  
Executive Vice President  
Public Policy and Advocacy  
SIFMA

cc: Honorable Gary Gensler, Chairman  
Honorable Bart Chilton, Commissioner  
Honorable Michael Dunn, Commissioner  
Honorable Scott O'Malia, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Commodity Futures Trading Commission  
Honorable Mary L. Schapiro, Chairman  
Honorable Luis A. Aguilar, Commissioner  
Honorable Kathleen L. Casey, Commissioner  
Honorable Troy A. Paredes, Commissioner  
Honorable Elisse B. Walter, Commissioner  
Securities and Exchange Commission  
Honorable Ben S. Bernanke, Chairman  
Honorable Janet L. Yellen, Vice Chair  
Honorable Elizabeth A. Duke, Governor  
Honorable Sarah Bloom Raskin, Governor  
Honorable Daniel K. Tarullo, Governor  
Board of Governors of the Federal Reserve System  
John Walsh, Acting Comptroller  
Office of the Comptroller of the Currency  
Sheila Bair, Chairman  
Federal Deposit Insurance Corporation  
Timothy Geithner, Secretary and Chair of the Financial Stability Oversight Council  
Department of the Treasury  
Leland A. Strom, Chairman and Chief Executive Officer  
Farm Credit Administration  
Edward DeMarco, Acting Director  
Federal Housing Finance Agency



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## DISCUSSION MATERIALS

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**Meeting With Securities and Exchange Commission,  
Friday, May 13, 2011 – Washington, D.C.**

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The Securities Industry and Financial Markets Association (SIFMA)  
prepared this material for discussion purposes only.

# Executive Summary Capital vs. Margin

## Capital Requirements:

- The minimum amount of Available Financial Resources (e.g. Tier 1 Capital, tangible common equity) a Financial Institution (FI) needs to avoid insolvency should be based on its Economic Capital – a measure of the unexpected loss the FI may have over a one-year horizon, at a very high confidence level (e.g. 99.95%).
- Economic Capital (EC) needs to capture all of the risks of the FI. For a trading portfolio of derivatives, EC will normally include counterparty credit risk, market risk and operational risk.

## Margin requirements (initial and variation)

- Margin protects an FI against losses from one component of counterparty credit risk – i.e. from economic losses caused by the default of a counterparty.

## Interaction of Margin and Capital

- Even if all derivative transactions of an FI had legally enforceable margin (initial and variation) agreements, the EC of the FI would not be zero because it would capture:
  - The residual counterparty credit risk - measured on a portfolio basis, across all counterparties, and at the very high confidence level – in the calculation of EC. In general, the higher the initial margin requirements the lower the required capital for counterparty risk.
  - All other forms of risk in the derivative portfolio, such as market risk.

# Executive Summary Capital vs. Margin

**Margin and Capital Requirements differ in many ways:**

| Feature                   | Initial Margin   | Capital Requirements based on Economic Capital  |
|---------------------------|--|---|
| Time Horizon              | <ul style="list-style-type: none"><li>• 5 to 10 business days</li></ul>  | <ul style="list-style-type: none"><li>• One year</li></ul>  |
| Confidence Level          | <ul style="list-style-type: none"><li>• CL of initial margin typically varies with credit risk of counterparty</li></ul> | <ul style="list-style-type: none"><li>• Very high confidence level. Regulatory capital is at nominal 99.9%.</li><li>• Many banks internal calculation are at 99.95% to 99.97%.</li></ul>                              |
| Risk Types Captured       | <ul style="list-style-type: none"><li>• Counterparty default risk</li></ul>  | <ul style="list-style-type: none"><li>• All risk types relative to business.</li><li>• For derivative trading portfolio this would include counterparty risk (including CVA risk), market risk and op risk.</li></ul> |
| Complexity of Calculation | <ul style="list-style-type: none"><li>• Simple, for ease of transparency with counterparty</li></ul>                     | <ul style="list-style-type: none"><li>• Complex calculations to capture all risks, in all their subtle forms, over a one-year horizon at a very high confidence level.</li></ul>                                      |

# Purpose of Economic Capital

- The two primary risks of a financial institution (FI) are funding liquidity risk and insolvency risk.
  - These risks are related, for example, the market's concerns about the likely insolvency of an FI can cause its funding liquidity to evaporate, however economic capital primarily addresses insolvency.
- To avoid insolvency an FI needs an amount of Available Financial Resources (AFR) that is larger than its potential unexpected losses, measured at some specified confidence level, over a specified time horizon.
- There are three common measures used to assess the capital adequacy of a regulated FI, all of which are required by Basel II:

| Measurement of Risk vs. AFR                          | Type of Model For Risk Measurement                                | Time horizon         |
|--|---|----------------------|
| Economic Capital vs. AFR                             | Internal Model  | 1 year               |
| Basel RWA vs. Tier 1 Capital                         | Mix of internal model, internal parameters and regulatory formula | 1 year               |
| ICAAP – Internal Capital Adequacy Assessment Process | Internal Model/Stress Test on revenue and potential losses        | Multi-years (e.g. 3) |

# Definition and Use of Economic Capital

**Economic Capital (EC)** is a common yardstick to measure risk, across all forms of risk and all types of business units of an FI.

- The primary purpose of the measurement of EC is the assessment of the capital adequacy of the firm from the perspective of insolvency risk. This sets the context for how EC is measured.
- Capital adequacy is assessed by comparing an FI's EC against its Available Financial Resources (AFR). FIs have used various measures of AFR, e.g. Tangible Common Equity.

**EC** is the potential unexpected loss of economic value over a one year horizon measured at a very high confidence level (e.g. 99.95%, 99.97%).

- **Unexpected loss** is the difference between loss at a very high confidence level and the expected loss.
  - The expected loss for market risk is zero.
  - The expected loss for the credit risk of a loan portfolio is greater than zero and should be covered by a Loan Loss Reserve (LLR)
  - The expected loss for operational risk is also greater than zero and should be covered by some combination of reserves and/or pricing.
- **One year horizon** is based on the assumption that an FI cannot continually raise equity and needs a capital buffer to absorb losses over one year and still be solvent.
- **Very high confidence level** reflects the need to have sufficient capital given an FI's target credit rating.
  - For example, if the through-the-cycle probability of default (PD) of an AA rated FI were 3bp, then to be AA rated an FI would have to have sufficient capital to absorb losses and remain solvent at the 99.97% CL.
  - Basel II, II.5 and III nominally measure economic capital at the 99.9%CL and then transform that measurement of risk into risk weighted assets by the formula:  $RWA = 12.5 * EC_{\text{Basel at 99.9\%CL}}$

# Regulatory Capital vs. Internal Economic Capital

A comparison of the measurement of economic risk and available financial resources over a one-year horizon from a regulatory (Basel) and an internal measurement perspectives

|                       | Measurement of Economic Risk:<br>Potential unexpected loss over one year at a very high confidence level.<br><i>“How high is the potential flood?”</i>   | Measurement of Available Financial Resources (AFR): Capacity to absorb unexpected losses and avoid insolvency.<br><i>“How high is the dam?”</i>  |
|-----------------------|--|--|
| Basel Measurements    | <ul style="list-style-type: none"> <li>• Risk Weighted Assets (RWA)               <ul style="list-style-type: none"> <li>– <math>RWA = 12.5 * Risk\ Cap_{Basel}</math></li> <li>– <math>Risk\ Cap_{Basel}</math> <ul style="list-style-type: none"> <li>▪ Basel CL nominally at 99.9%</li> <li>▪ Capital Horizon of one year</li> </ul> </li> </ul> </li> </ul>  | <ul style="list-style-type: none"> <li>• Tier 1 capital</li> <li>• Tier 1 capital + Tier 2 capital               <ul style="list-style-type: none"> <li>– The definition of “Tier 1” and “Tier 2” capital changes materially under Basel III compared to Basel I and Basel II</li> </ul> </li> </ul> |
| Internal Measurements | <ul style="list-style-type: none"> <li>• Economic Capital</li> <li>• Advanced banks use more sophisticated measures than Basel’s Pillar 1 prescribes.               <ul style="list-style-type: none"> <li>– Usually measured at a higher confidence level than Basel</li> <li>– Takes into account portfolio effects and risk concentration for credit risk and across risk types</li> <li>– Captures all risk types, not just those specified by Pillar 1</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• FIs use various measures of AFR.               <ul style="list-style-type: none"> <li>– One example of AFR, used at some FIs, is Tangible Common Equity, adjusted to include Mortgage Servicing Rights</li> </ul> </li> </ul>                               |

# Economic Risks of Derivatives Portfolio

EC (and Basel RWA) need to be calculated for three types of risks of a trading portfolio of derivatives:

- 1) EC for market trading risk.
- 2) EC for counterparty credit risk.
  - **Under FAS 157 (fair value accounting)**, counterparty credit risk is treated as a component of market risk. The mark-to-market value of a portfolio of derivatives includes:
    - A “counterparty credit risk free” market value, obtained by discounting all expected future cash flows at LIBOR (or a similar rate, e.g. OIS), independent of the counterparty.
    - A Credit Value Adjustment (**CVA**), a market based estimate of the relative credit risk of trading with the counterparty.
  - **IFRS** does not require the marked-to-market calculation of a CVA, in contrast to FAS 157.
  - In spite of the fact that the requirements of FAS 157 are not implemented under IFRS, the BCBS requires, in **Basel III**, that FIs include the volatility of the CVA in their calculation of total RWA for counterparty credit risk. This is a very material change from the treatment of counterparty credit risk under Basel I and Basel II
    - **Basel I** and **Basel II** treat counterparty credit risk as a type of wholesale credit risk, albeit one with a potentially higher future exposure due to potential changes in market rates. The potential increase in exposure due to changes in market rates is captured by a crude method under Basel I and a more sophisticated method under the Internal Model Method of Basel II.
    - In contrast, under **Basel III**, RWA for counterparty credit risk includes a component for the potential volatility of the CVA in addition to the potential loss due to a downgrade or default by the counterparty.
- 3) EC for operational risk.

# Definition and Purpose of Margin

- **Legally enforceable margin agreements** reduce counterparty credit exposure for derivatives and consequently reduce the economic capital for counterparty credit risk required for such transactions.
- For a daily margin agreement with zero threshold:
  - **Variation margin and initial margin** can be calculated for each separate derivative transaction or, under a legally enforceable netting agreement, can be calculated on a net basis for all derivatives under that netting agreement.
  - **Variation margin** is posted daily if the MTM value of a contract (or the net MTM value of a portfolio) is negative from the counterparty's perspective. The purpose of the counterparty posting variation margin is to cover the cost of replacing the derivatives with that counterparty, should the counterparty immediately default - or, more precisely, cover the cost of replacing the transactions with the defaulted counterparty with a replicating portfolio of equivalent market risk.
  - **Initial margin** is posted by the counterparty to cover the potential additional decrease in the market value of the contract (or portfolio of contracts) from the counterparty's perspective over the “margin period of risk” – see next page.
  - **The market value** used to determine the magnitude of the variation margin and used to simulate the amount of required initial margin, is the “counterparty risk-free” market value, i.e. the market value of the derivative (or net value of a derivative portfolio) ignoring the CVA. In other words it is the market value calculated by discounting all future cash flows at LIBOR (or a similar rate, e.g. OIS).

# Standards for measuring initial margin

- **Initial margin** is needed to cover the potential increase in exposure to a counterparty over the margin period of risk.
  - **The potential increase in exposure** can be calculated on either a net portfolio basis (when there is a legally enforceable margin agreement) or on an individual contract basis (if there is no legally enforceable margin agreement, or if the counterparty chooses this approach).
  - The margin period of risk is typically between 5 to 10 days and will depend on:
    - The time interval between marking-to-market for margin calls (e.g. one day)
    - A time interval to take into account grace periods, if any, for the counterparty to post margin.
    - A time interval to take into account how long it would take to replace the derivatives with the defaulted counterparty with a replicating portfolio with the same market risk.



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**Security-Based Swap Dealer and Swap Dealer Capital Requirements  
under Title VII of the Dodd-Frank Act**

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**Meeting With Securities and Exchange Commission, Commodity Futures  
Trading Commission and Federal Reserve Board  
Friday, April 15, 2011 – Washington, D.C.**

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The Securities Industry and Financial Markets Association (SIFMA) prepared this illustrative material for discussion purposes only.

# Swap Dealer Capital Requirements

## Introduction

- Swap dealers should use risk-based methods, such as models, for computing capital requirements.
- Large global financial institutions use models and other risk-based methods to manage risk and determine appropriate levels of capital.
- Regulators in major financial centers around the world have incorporated model-based capital requirements into their regulations.
- If regulators in the U.S. and globally take different approaches to determining capital requirements, competitive advantages and disadvantages are likely to result.
- A grid-based approach would be inferior to a risk-based method for computing capital.

# Attributes of a Good Capital Regime: Grids vs. Models

## Attributes of a Good Capital Regime

- Risk sensitive.
- Accurate at both trade and portfolio levels.
- Minimizes unintended consequences and bad behavior.
- Consistent with business risk-management processes.

## Comparative Advantages of Models and Grids

- Grids: simpler to use
- Models: risk sensitive; recognize different risks within portfolios of many complex and different products; accurate at trade and portfolio levels; recognize diversification and concentration of risk; utilize back-testing and feedback loops; readily adjust capital requirements as risks are identified; minimize unintended consequences and bad behavior; consistent with business risk-management processes; consistent with global regulatory models

# Model Governance and Uses

## **VaR-Based Models are Subject to Rigorous Development and On-Going Validation**

- Model governance includes model development and model validation conducted by separate teams with separate reporting lines; regulators subject models to rigorous approval processes.
- VaR models are back-tested daily and stressed tested regularly.
- Internal and external auditors provide independent review and oversight of models.
- Risks not adequately captured by VaR are identified and monitored separately.

## **VaR is an important tool in monitoring aggregate market risk exposures**

- Important uses of VaR models include estimation of economic and regulatory capital, risk management and capital allocation, and public reporting.
- VaR numbers are produced daily and subject to a large number of control processes.
- VaR numbers and compliance with VaR limits are monitored daily.
- VaR numbers are reported to and well-understood by front office staff, senior management, and Boards of Directors.

# Model Performance and Development

## How Well Does VaR Perform in Measuring and Managing Risk?

- On the vast majority of trading days, VaR models perform well.
- During periods of market stress, VaR models can have lower predictability.
- VaR should not be the sole measure for determining economic capital because it does not take into account certain market factors such as illiquidity and extreme widening of credit spreads.
- Back-testing and feedback provide an accurate view of VaR models' shortcomings so that compensating steps can be taken.

## Models Have Been Improved

- Regulators have introduced stressed VaR, incremental risk charges (IRC), and comprehensive risk measures (CRM).
- Firms have enhanced their own economic capital models to reflect levels of liquidity.

# Shortcomings of Grids

- Updated infrequently.
- Are product based and do not recognize cross-product hedging and other risk management techniques.
- Not internally consistent.
- Allow for recognition of a limited number of risk factors; fail to take others into account.
- Not used in managing financial businesses.
- At odds with global norms.
- Very difficult, and perhaps impossible, to make risk-sensitive and to align with other regulatory regimes.