Why Basel III Endgame & GSIB Surcharge proposals are necessary for the largest banks

Remarks to the Energy & Environmental Markets Advisory Committee
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Apr 10, 2024

Thank you for the opportunity to join the Energy and Environmental Markets Advisory Committee to talk about the importance of the large bank capital proposals. This includes the Basel III Endgame and the GSIB surcharge proposal.[1]

I work for Americans for Financial Reform Education Fund. We are a nonpartisan and nonprofit coalition of more than 200 civil rights, consumer, labor, business, investor, faith-based, and civic and community groups. We are dedicated to advocating for policies and a financial sector that serve workers, communities, and the real economy, and provides a foundation for advancing economic and racial justice.

Prior to joining AFREF, I worked in banking and supervision. This included working in enterprise risk at UBS and in market risk at Deutsche Bank over eight years, and working in bank supervision for the Federal Reserve Bank of New York for ten years ending in 2010.

The agencies should finalize the proposals with the main components intact, incorporating only a select set of appropriate tweaks. The additional capital would increase big banks' balance sheet strength and financial system resilience, serving to mitigate against the risks to firms and to the system of a severe financial crisis. The GSIB surcharge proposal would properly incorporate derivatives enhancements, amending the complexity and interconnectedness indicators to include cleared OTC derivatives provided to clients under the agency model. The Basel III Endgame proposal would introduce standardized, non-model approaches to improve the risk sensitivity of CVA to losses on certain derivatives. It would recognize higher derivative exposures in the standardized approach to measuring counterparty credit risk than the internal model method and thus warrant higher capital levels.

- **Crises are bad for everyone, making the incremental costs well worth the benefits.**

No one wants to go through the 2008 financial crisis again, but we cannot just hope that the biggest banks will be more careful. Wishful thinking will only encourage future financial crises.

[1] This includes the Board of Governors, the FDIC and OCC's Regulatory Capital Rule for Large Banking Organizations and Banking Organizations With Significant Trading Activity and the Board of Governors' GSIB Surcharge and Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15).

The large bank capital and GSIB surcharge proposals address the chronic problem of undercapitalization of the largest banks. The proposals, once implemented, would help to lower the risk and severity of financial crises and the resulting financial turmoil that puts households and businesses' financial security at risk.

The proposals would do this by requiring the largest banks to hold more capital for their actual risk taking. Right now, the biggest banks capture all the upside gain from outsized risky investments but the public bears all the downside risk — we pay for the crises through job losses and foreclosures and taxpayer bailouts. The largest banks — particularly the too-big-to-fail banks — would appropriately carry more of the weight and responsibility for holding big enough capital cushions.

The 2008 crisis robbed millions of Americans of their wealth and homeownership, with particularly devastating impacts on people and communities of color. Capital requirements based on risk exposures that are captured and measured appropriately, including clearing related derivative exposure, will reduce speculative bubbles like those that fueled the subprime crisis and make the financial system safer for everyone.

- **Derivatives increased leverage, interconnectedness, and complexity prior to 2008, and the industry continues to pursue outsized leverage in ways that create vulnerability.**

During the 2008 crisis, some financial institutions with highly leveraged derivatives positions faced steep declines in value (especially those tied to mortgage-backed securities like credit default swaps). These contributed to the collapse of dozens of financial institutions. Banks need to maintain capital levels to more accurately reflect the risk that these derivative positions could pose to institutional safety and soundness and to the financial system.

Derivatives played a central role in the failures or near failures of Lehman Brothers,[2] AIG,[3] and other firms. The most notable failure among commercial end users in the early 2000s was that of Enron, which saddled JPMorgan and Citigroup with billions in credit losses and legal liabilities.[4] Subsequently, Amaranth Advisors' excessive speculation in natural gas in 2006

[2] Fleming, Michael J., Asani Sarkar. "The Failure Resolution of Lehman Brothers." Federal Reserve Bank FNew York Economic Policy Review. December 2014.
[3] Hearing Before the Committee on Oversight and Government Reform. "The Causes and Effects of the AIG Bailout." October 7, 2008.
[4] White, Ben, Peter Behr. "Citigroup, J.P. Morgan Settle Over Enron Deals." Washington Post. July 28, 2003.

distorted prices, increased volatility, and increased costs and risks for natural gas consumers who ultimately pass on inflated costs to their customers.[5] Official sector studies during 2007-2009 documented the ways in which speculative futures trades contributed to spiking energy[6] prices and global food instability.[7] Since then, clearing brokers have had few incentives, it appears, to rein in the dramatic growth in financial end-users' participation in commodity futures markets. The proposed capital rules would increase large banks' loss absorbing capacity and hold the largest banks, including those serving in clearing roles, more accountable for this risk taking.

- **The largest banks and financial end users' outsized derivative positions continued to compromise clearing members' safety and soundness and financial stability after Dodd-Frank, including for commodities**

After Dodd-Frank's passage, several firms continued to accrue outsized cross-border swap and other derivative concentrations that undermined their safety and soundness and introduced systemic risk to key markets, including commodities. JPMorgan Chase's outsized London whale[8] exposures in 2011-2012 and the failure of Archegos[9] Capital Management in March 2021 were among the most severe derivatives fueled events that prompted market turbulence, substantial losses and official sector inquiries in their aftermath. Archegos prompted Credit Suisse, among other firms, to lose billions of dollars and precipitated its slow descent to a forced merger with UBS in March 2023.

Large scale failures like that of Lehman Brothers had substantial consequences for derivative trading desks and the end user community. Lehman's uncleared derivative counterparties filed claims totalling $51 billion in relation to its derivatives business, and it was four years before the first payments were made to these uncleared derivative creditors.[10] By avoiding scenarios like

[5] United States Senate Permanent Subcommittee on Investigations/ Committee on Homeland Security and Governmental Affairs. "Excessive Speculation in the Natural Gas Market Staff Report." June 25, 2007.
[6] Williams, Orice M. "Preliminary Views on Energy Derivatives Trading and CFTC Oversight." Testimony Before the House Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture. July 12, 2007.
[7] "Casino of Hunger FOOD How Wall Street Speculators Contributed to the Global Food Crisis."
[8] "JP Morgan Chase Whale Trades: A Case History of Derivatives Risk and Abuses."Hearing Before The Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate. March 15, 2013.
[9] Patrick, Margot. "Credit Suisse's Archegos Disaster Exposes Cracks in Bank Regulation Trades routed through London weren't in the scope of Federal Reserve stress tests of Credit Suisse's U.S. trading arm this year." Sept. 21, 2021.
[10] Bowers, Simon. "Derivatives worth hundreds of billions start to unwind." The Guardian. Oct 10, 2008.

Lehman and the London whale, we avoid being stuck in a perpetual state of financial market fragility. Whatever that small incremental increase is, it is worth it. The benefit is fewer and less severe Lehman Brothers, London whale and Archegos events, where derivatives have been the mechanism for leverage.

- **Derivative concentrations remain a threat to financial stability.**

While end user financial hedging is often characterized as low risk, it is not risk-free for central counterparties and for the large banking organizations that serve as clearing members. "Default estimates have again been on the rise for a variety of CCPs, including those with significant exposure to commodity markets," according to the Financial Stability Oversight Council's 2023 annual report.

This recent rise in risk perceptions may be, at least in part, a response to the serious stresses that occurred on the LME in March 2022.[11] Better capitalized derivatives exposures would help to prevent the build up of excessive commodities concentrations and strengthen stakeholders' confidence in vulnerable central counterparties and their clearing members.

- **GSIB proposal appropriately adds derivatives to cross-jurisdictional activity.**

The absence of derivatives in the current GSIB surcharge framework results in a significant understatement of the systemic risk in cross jurisdictional activity. The GSIB proposal would revise the cross-jurisdictional activity indicator in the GSIB surcharge framework to include cross border derivatives exposures not captured currently, thus making the measure more sensitive to actual risks.

Including derivatives would have the greatest impact on large organizations that are not GSIBs since the cross jurisdictional activity measure is also an indicator for determining the large banks' tailored supervision category. Thus, some firms in the lower categories of the Fed's tailored supervision framework, with the inclusion of derivatives exposure, would advance to the next tailoring category and *appropriately* be subject to more stringent capital and liquidity requirements.[12]

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[11] Financial Stability Oversight Council. "FSOC 2023 Annual Report".
[12] Sources: Federal Reserve Bank of Chicago. "Can Broader Access to Direct CCP Clearing Reduce the Concentration of Cleared Derivatives?" Economic Perspectives. Vol. 43. No. 3. December 2019.

- **Basel III Endgame market risk, operational risk and CVA reforms would also appropriately require capital for these risks.**

The proposed rule addresses distinct financial losses and risks that have different root causes. The rule appropriately confronts these separate risks individually and far from including redundant requirements, this layered approach provides needed safeguards for each discrete category of risk.

- *Market risk* capital cushions the risk of loss from changes in mark to market price of traded positions. The proposal increases consistency and risk sensitivity and incorporates a tail risk into the measurement of market risk.

- *Operational risk*[13] includes, among other things, how well financial and non-financial risks are controlled and external factors in capital markets businesses. It can result in direct losses and can magnify losses associated with market, traded credit or liquidity risks.

- *Credit valuation adjustment* (CVA) refers to adjustments to transaction valuation to reflect a counterparty's credit quality.

  In light of the number of financial firms struggling or failing in 2008, market participants started incorporating CVA risk when calculating the value of over-the-counter derivative instruments.[14] A large portion of CCR losses were because of CVA losses rather than actual counterparty defaults. The proposed rule would require banks to replace the current bespoke model based approach with more standardized, non-model approaches which would improve the sensitivity of CVA risk to losses on certain derivatives. *This may or may not be an area the agencies are reviewing for its impact on end users.*

While there is some interplay between these risks, it is important to have distinct capital requirements to address distinct risks.

- **Regulations play a minor role in the consolidation of derivatives clearing.**

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[13] Definition: Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.
[14] Office of the Comptroller of the Currency. "Interagency Supervisory Guidance on Counterparty Credit Risk Management." June 29, 2011.

The largest banks are claiming that they would need to pass costs of additional capital requirements along to derivative end users. They are raising concerns about further consolidation among clearing members. However, a broader set of economic trends have contributed to the shrinking number of futures commission merchants that provide derivatives clearing services. This has occurred over about twenty years starting in 2002.[15] And, this is part of the dangerous consolidation trend in financial services and the economy over the past forty years. The insolvencies and bankruptcies of a number of FCMs over seven years from 2005 to 2012 contributed to the FCM consolidation.[16] The right response to these trends is to restore a more competitive clearing market, not to block measures that would increase safety and soundness across the system and prevent more FCM insolvencies.

The large banks' dual roles as swap dealers on the one hand, and clearing members of central counterparties for exchange traded derivatives on the other, make them even more systemically important after Dodd Frank. Their dual role introduced notable conflicts of interests,[17] according to congressional studies mandated by Dodd Frank, that make appropriate capitalization of their own derivative positions even more important.

- **The clearing cost estimates suggest even the high estimates would be very modest.**

The rule will probably make derivatives clearing transactions slightly more expensive. The industry estimates that the impact on derivatives trading could reach $7 billion, which may sound like a huge cost, but it is really a small impact relative to the scale of the regulated derivative market. For example this $7 billion increase would be less than one percent or 0.4% of the $2.2 trillion[18] in gross positive market value of derivatives held mainly by the banks that would be subject to these rules. Put another way, the $7 billion would amount to three tenths of a penny per contract if spread across CME's 24.4 trillion derivative contracts in 2023.[19]

That is just the CME contracts, but it gives you a sense of how little this will raise costs on a per cleared contract basis. To put this three tenths of a penny into perspective, typical commodity

[15] Alvarez, Nahiomy. "Can Broader Access to Direct CCP Clearing Reduce the Concentration of Cleared Derivatives?" Federal Reserve Bank of Chicago. Economic Perspectives. Vol. 43. No. 3. December 2019.
[16] Emm, Ekaterina E., Gerald D. Gay, Mo Shen."Futures commission merchants, customer funds and capital requirements: An organizational analysis of the futures industry." Journal of Commodity Markets 18 (2020). This includes, among others: Refco (2005), Sentinel (2007), Lehman Brothers (2008), MF Global (2011), and Peregrine Financial Group (2012).
[17] "Conflicts of Interest in Derivatives Clearing." Congressional Research Service. March 22, 2011.
[18] "Quarterly Report on Bank Trading and Derivatives Activities." First Quarter 2023 Office of the Comptroller of the Currency Washington, D.C. June 2023
[19] "CME 2024 Proxy Statement." January 3, 2024.

future execution and clearing fees may be in the vicinity of $1.50 - $2.25 per contract.[20,21] Where there are incremental costs, they must be balanced against the benefits of having more resilient counterparties and a reduced likelihood of another London whale, Lehman Brothers or Archegos.

- **The industry is crying wolf over the capital rule.**

As part of a well funded campaign to try to stop or dilute the rule, the big banks are telling a very misleading set of stories about its impact. Federal Reserve Board Vice Chair of Supervision Michael Barr has noted that the largest banks either already have enough equity capital to meet the new requirements or would not need to raise additional equity to meet them.[22,23]

Thank you for the opportunity to share AFREF's perspective. I welcome any questions.

[20] CME. "The Big Picture: A Cost Comparison of Futures and ETFs." February 4, 2016.
[21] https://www.tradestation.com/pricing/exchange-execution-and-clearing-fees/
[22] Schroeder, Pete. "What is the Basel III Endgame and Why Are Banks So Worked Up About It." Reuters. April 4, 2024.
[23] Board of Governors. Vice Chair for Supervision Michael S. Barr Remarks. "Holistic Capital Review." Bipartisan Policy Center. July 10, 2023.