United State House of Representatives

Committee on Agriculture

Clearing the Next Crisis: Resilience, Recovery and

Resolution of Derivatives Clearing Houses

Statement of John Dabbs, Credit Suisse Global Head Prime Derivatives Services

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Chairman Conaway, Ranking Member Peterson and Member of the Committee thank you for holding this important hearing and for the opportunity to present our views.

Introduction

My name is John Dabbs and I am the global head of Credit Suisse' cleared derivatives business. Credit Suisse Securities (USA) LLC ("CSSU" or "Credit Suisse") is a U.S. futures commission merchant ("FCM") registered with the Commodity Futures Trading Commission ("CFTC") and the National Futures Association ("NFA"). CSSU clears derivative contracts-traded on exchanges, swap execution facilities ("SEFs") and in the over-the-counter ("OTC") derivatives markets directly through clearing house memberships and indirectly through affiliates.

Credit Suisse is a direct member of the following central counterparties ("CCPs"): the Chicago Mercantile Exchange Inc.'s clearing division(" CME"), Intercontinental Exchange's ICE Clear US, ICE Clear Credit and ICE Clear Europe and the London Clearing House's LCH.Clearnet, each of which is registered with the CFTC as a derivatives clearing organization "DCO").

Credit Suisse fully supports the clearing model and the efforts of regulators, clearing houses, clearing clients and clearing firms. Clearing has existed for decades and while it functioned extremely well during the financial crisis, it has grown considerably as a result of mandatory clearing under Dodd Frank. As the cleared derivatives markets and CCPs continue to expand and evolve, it is worth reviewing the model now with an eye towards promoting CCP resilience and reducing the risk of CCP recovery and resolution. We discuss aspects of the clearing model below, particularly the role of the clearing member, benefits and challenges of clearing, CCP resilience, recovery and resolution and finally the recent EU CCP supervisory proposal.

Clearing Member Role

Clearing members are the cornerstone of the cleared derivatives process. They act as intermediaries between clearing clients and CCPs. Clearing members provide clients with a portal through which they may access clearing by acting as their agent and guaranteeing their financial

obligations to the CCP.[1] In addition, clearing members provide guaranty fund contributions to the CCP in an amount that is proportionate to the amount of risk carried in the clearing members' client portfolio. Clearing members are heavily regulated and provide an array of services to clients such as collecting margin, sending client statements and providing various operational efficiencies.

Client Clearing Benefits - General

Clearing provides many benefits to clients. Clearing reduces counterparty risk, since CCPs act as the buyer to every seller and seller to every buyer to ensure financial security in the marketplace. CCPs pay to one party to a derivative contract what they receive from the other party. Clients face a CCP as their counterparty to a derivative transaction as the CCP takes the other side of the client's trade. In an uncleared derivative, clients face various swap dealers, who are mostly banks or bank affiliates, and, as a result, face the risk of a default of each such counterparty.

Clearing reduces default risk through a performance bond system with daily mark-to-market payments. Clearing clients post initial margin to the CCP through their clearing members on each cleared contract and pay or receive daily variation margin payments based on market movements.

Client Clearing Benefits – Clearing Members

Clients access CCPs through clearing members and, as discussed below, CCPs impose numerous financial, capital, regulatory, operational and other requirements on clearing members that clearing clients either cannot or prefer not to undertake.

One of the basic tenets of client clearing is client fund protection. Clients of clearing firms who are registered as FCMs benefit from a robust regulatory client protection regime under the US Commodity Exchange Act, U.S. Bankruptcy Code, CFTC, NFA and CCP regulations.

Clearing member FCMs are regulated by the CFTC, NFA, exchanges, CCPs and SEFs. They undergo periodic external and internal audits as to their compliance with applicable rules and regulations. Clearing firms:

- segregate client funds from house funds;
- are subject to restrictions on their use of client funds;
- establish client margin levels;
- establish and monitor risk based limits for each client;
- monitor client positions throughout the trading day;
- conduct stress tests of client portfolios;
- establish and monitor a robust risk management program;
- establish processes and procedures for client on-boarding, including reviewing and monitoring client financial condition;
- provide early warning notifications to regulators including immediate notice if:
    - the FCM clearing member is undercapitalized, or
    - the client segregation pool does not hold a sufficient amount of funds;

[1] Clearing members do not guarantee the financial obligations of the CCP to their clearing clients.

- comply with financial requirements, including contributions of a certain amount of their own funds to the client segregation pool and restrictions on amounts that can be withdrawn;
- comply with disclosure requirements to clearing clients at the inception of the relationship and provide public disclosure of certain clearing member information; and
- are subject to regulatory capital requirements, including CFTC requirements and, if: a) a joint FCM-broker dealer, SEC requirements, and (b) if a bank or bank affiliate, prudential regulatory requirements.

Client Clearing Benefits - CCPs

CCPs are also regulated by the CFTC and are subject to DCO core principles set forth in the Commodity Exchange Act and CFTC Regulations. CCPs impose strict membership criteria such as adequate financial assurances, contributions to the guaranty fund, assessment rights, capital requirements, operational and technological requirements and demonstration of market and product knowledge and experience.

Additional CCP requirements include robust CCP risk management, financial safeguards, such as performance bond and daily mark-to-market payments, surveillance and audit functions of clearing members and imposition and monitoring of position limits. CCPs:

- segregate client clearing funds from clearing member and CCP house funds;
- are subject to restrictions on CCP use of client funds;
- establish clearing member margin levels;
- establish and monitor risk based limits for each clearing member
- monitor clearing member positions (house and client) throughout the trading day;
- conduct stress tests of clearing member portfolios;
- establish risk management program; and
- review and monitor clearing member financial condition.

In the event of a clearing member default, CCPs typically work to identify non-defaulting clearing members for purposes of transferring client positions and related margin.

Each CCP is required to establish financial safeguards that typically contain a "waterfall" setting forth the sequence in which various risk management and loss mutualization mechanisms would be employed in the event of a clearing member default.

Clearing Member Perspective

Clearing members view their role as similar to that of CCPs. CCPs run matched books and do not introduce market risk into derivatives markets. Clearing members are also market neutral. They perform agency and market intermediary services for clearing clients and are not principal counterparties to the underlying derivatives contracts. As clearing members guarantee the financial performance of their clients to the CCP, they are exposed to client credit and default risk. CCPs are exposed directly to the credit and default risk of their clearing members and indirectly to credit and default risk of the clearing member's underlying clients. Although, while clearing members are subject to regulatory capital rules of the CFTC and bank clearing members are also subject to

regulatory capital requirements of prudential regulators, CCPs are not subject to capital requirements.

In the event of a clearing member default, non-defaulting clearing members are at risk of mutualized default losses, i.e., covering losses from the non-defaulting clearing members' guaranty contributions and assessments.

Clearing Challenges

Prudential Regulators Capital Requirements – Basel III, IHC, CCAR

One of the major challenges to the clearing objectives of the G-20 Pittsburgh Summit and Dodd Frank is the impact of the regulatory capital regime.

Basel III imposed numerous capital requirements on banks and bank affiliates. Two major components relate to risk weighted assets (RWA) and the leverage ratio. As currently implemented by prudential regulators Basel III disincentives client clearing and threatens the model for clients of the highest credit quality. Issues include reducing client access to clearing and challenges associated with transferring a defaulting member's client portfolios. The number of clearing firms is decreasing while client clearing is increasing, creating concentration and systemic risk.

Risk Weighted Assets ("RWA")

Basel III for the first time requires clearing member firms to obtain legal certainty, (*e.g.*, legal opinions from external counsel) that speak to the issues of collateral enforceability and "netting", i.e., net exposure in the event that a clearing client were to default and or become insolvent. Such legal opinions must be obtained by law firms who are experts in the governing insolvency laws relevant for the form of organization of the clearing client in the client's jurisdiction (i.e., a pension plan organized under the laws of particular state or a clearing clients organized under the laws of a non-US jurisdiction).

There are certain jurisdictions and/or forms of organization of clearing clients that pose major challenges in obtaining a netting opinion. The result is that the clearing member's RWA capital requirement is calculated on a gross and not net basis, resulting in some clearing clients not being able to find a clearing member that can clear for them.

Supplemental Leverage Ratio ("SLR")

The Basel III Supplemental Leverage Ratio ("SLR") raises several issues. First, a clearing member bank may not reduce its SLR exposure by the amount of initial margin that it collects from its clearing clients and posts to the CCP and/or holds in a client segregated account, as required by CFTC regulations.

Second, the SLR includes a punitive add-on factor to the measure of a bank's exposure for certain types of clients (i.e., high credit quality clients such as pension plans and insurance companies) who tend to trade directional, longer term portfolios. The add-on factors are based on the types of cleared products and time to maturity. For example, the add-on factor for an interest rate product with a maturity over five years is 1.5% and that of "other commodities" with the same tenor is 15.0%. The add-on factors provide a perverse incentive for an FCM bank clearing member to clear for high turnover speculators rather than low turnover hedgers.

Clearing clients have less access to clearing as the SLR provides barriers to entry for new clearing members and results in clearing members exiting the business or terminating client relationships with a non-SLR friendly portfolio.

In a clearing member default, porting will be difficult as CCPs and regulators may not able to find another clearing member willing and/or able to take on the defaulting clearing member's client portfolios.

Comprehensive Capital Analysis Review ("CCAR")

CCAR and the Dodd-Frank Act Stress testing are part of the evolution of US bank capital requirements in the wake of the financial crisis. Both of these exercises are administered by the Federal Reserve and require, among many other things, banks and certain affiliates to perform stress tests on their client's cleared derivative portfolios that do not take into account the credit worthiness or the probability of default of a clearing client under the stress scenarios. As a result, the most challenging clients under these tests prove to be real money investment vehicles, corporate, insurance companies and public pension plans as they clear required hedging positions in derivatives. When, as CCAR and the cleared derivatives are viewed in isolation from the commercial positions being hedged and ignoring the financial wherewithal of the client, the positions are likely to be identified as inconsistent with the CCAR limitations. The practical result is that clearing firms who are bank affiliates are required to hold significantly more capital, collect higher margin or reduce their clearing business with such clients - often some of the most highly regulated, well-funded and moderately positioned of the universe of market participants.

Risk Mitigation versus Exacerbating Liquidity Risk

Mandatory clearing, as implemented by the prudential regulators in the US, has more often than not contributed to deeper, broader and more resilient liquidity. This is because clearing allows for additional market participants who can take and provide liquidity without transacting exclusively with bank dealers. However, capital standards pursuant to Basel III, particularly the measures and ratios for leverage and risk exposures, and the requirements to post and otherwise administer substantial collateral balances for uncleared derivatives have reduced liquidity when there is no available, or mandated cleared alternative. The simultaneous decisions made to require clearing, constrain clearing and constrain trading in non-clearable instruments reflect an effort to solve several perceived problems at once, instead of perhaps promoting clearing as a primary objective for a transitional period of years before adopting disruptive constraints on clearing and non-clearable instruments.

CCPs – Resilience, Recovery and Resolution

Clearing Eco-System and Interconnectedness

The clearing eco-system has grown significantly with the introduction of mandatory clearing and other policy prescriptions implemented in the aftermath of the financial crisis. As previously discussed, clearing offers many benefits to help control and mitigate risk at the systemic level. While central clearing would not have addressed all the issues associated with the financial crisis, it would have mitigated certain aspects. Viewed in hindsight, clearing houses and their members had continued to provide clearing services during the crisis even as the bilateral markets

suffered a domino collapse. By reconfiguring the otherwise random and often duplicative interconnections among market participants and introducing a layered package of financial backstop, clearing provides a level of systemic safeguards and resilience that was not present in the pre-crisis derivatives markets.

However, we note that certain trends may have worked to reinforce a linier consolidation of interdependencies that may lead to perverse outcomes in distress scenarios.

The first of these is a misalignment in financial package priorities that incentivizes a "bank run" on the clearing house. The current package was designed for a mutualized structure where clearing members and clearing house owners were one and the same. As membership and ownership diverged, members have become the primary bearer of clearing house risks while all profits are captured by owners, at little or no cost of capital. In an extreme but plausible scenario, members could be forced to contribute enormous amounts of funds in guaranty fund contributions, assessments, etc., while the clearing house could pay a substantial dividend to its investors. Moreover, the design of the clearing house financial package provides no legal certainty to clearing members for a full recovery of their default management contributions, even after the clearing house has been "bailed out" by clearing members and has returned to profitability.

Inevitably, this structure creates a tremendous disincentive to remain as clearing members, in any distress scenario and certainly during a clearinghouse recovery or resolution. The disincentive is further amplified by a fundamental shift in any rational expectation for clearing house risk management practices.

In addition, the clearing houses continue to become more interconnected to the banking system as some of the largest client clearing members are also the largest market makers, liquidity facility providers and custodians. There are inadequate incentives for clearing houses to diversify the risks beyond the silo'ed measure of "Cover Two", i.e., safeguards that are intended to cover only the largest two of the clearing house's members.

Fed Access

ALL CCP's (not just SIDCO) should have access to the fed for deposits and SIDCO's should have access to the Fed to borrow on a secured basis for converting US Sovereign Debt into cash during a time of stress. Together , these greatly reduce the interconnectedness of the CCPs and banks and additional stress placed on banks during a time of stress.

Skin in the Game

Skin in the game is an important element of the CCP financial safeguards package and should have a minimum standard that scales as a clearinghouse grows (or shrinks). We also think scaling it to the largest clearing member's default fund contribution creates the right incentive to diversify risk.

CCP Recovery

CCPs in time of Crisis and Severe Stress

One issue that CCPs and regulators will face in the event of a double default, i.e. a clearing default that results in a clearing member default, is that porting, an essential element of an orderly default management, may not be an available option due to the impact of regulatory capital requirements. The RWA and leverage ratio issues impede a clearing member's clearing capacity. A clearing member may not be able to accept a non-leverage ratio friendly portfolio even though such portfolio would be fully margined and otherwise pose no additional exposure if measured under conventional risks metrics.

Recovery and resolution will always be most successful when the process is well-articulated and understood beforehand by the entire ecosystem. Key stakeholders must maintain a regular dialogue throughout the process and providing decisive and consistent guidance to end users and infrastructure providers. The primary prudential regulator of the applicable CCP should be responsible for approving and administering the resolution structure. The applicable Federal Reserve banks should coordinate with and support the primary regulator in preserving necessary clearing member engagement and addressing any funding or liquidity challenges.

Clearing participants should be given a meaningful level of input with respect to a CCP's assumption of risk, post-default risk management decisions and other corporate governance decisions that materially affect the allocation of risks and potential losses that non-defaulting clearing participants may incur in connection with a clearing participant default. In particular, CCP rules and applicable regulations should provide legal certainty as to how impacted participants will be compensated for losses that participants may incur where the CCP avails itself of loss mutualization measures such as default fund assessments and variation margin gains haircutting.

Clearing Client Guaranty

When re-establishing a matched book, CCP's need a mechanism for clients to continue to perform on their positions (i.e., continue to pay margin) that are cleared through a defaulted clearing member. Allowing clients to directly guarantee their trades, at least for a short period of time, would greatly reduce the risk to the system and allow regulators and a bankruptcy trustee to quickly identify the good (paying) clients from the bad (defaulting) clients. Currently, as clients are understandably reluctant to pay margin to a distressed clearing member, all clients look the same on such clearing member's the books and records.

CCP Resolution

In a CCP resolution proceeding, clearing participants should retain claims for the full amount of clearing participant losses associated with a CCP's use of such measures. Such claims should (i) be senior to existing CCP equity in the creditor hierarchy, (ii) not be extinguishable in resolution or post-resolution prior to full satisfaction or conversion into an instrument of equivalent value, and (iii) entitle claimants to future CCP accumulated earnings or returns in excess of regulatory capital requirements until they are paid in full (and during such time, both the CCP and its parent should be prohibited from paying dividends).

Non-default losses should be covered entirely by the CCP and should not be covered by member resources.

In the event of CCP resolution, cleared contracts should be transferred to another CCP; however, this may not be possible for all contracts. For example, equity Index futures clearing continues to grow at CCPs. During a severe CCP stress situation, there may not be alternative CCP's because of licensing agreements. Liquidity of many bond, interest rate and commodity contracts could conceivably move or be setup at alternative CCP's, however things like the S&P 500 futures are exclusively listened by a single exchange/ CCP.

EU Proposal on CCP Supervision (June 13, 2017)

We welcome the European proposal for mandatory joint supervision of non-EU CCPs that are deemed "systemically important" to the EU. The newly announce approach is a preferable alternative to any mandatory general CCP location policy. The proposed model seems to address regulatory concerns in a less disruptive manner than ideas that have previously been considered. The new proposal is largely consistent with that which is already implemented by the US CFTC. The CFTC approach requires foreign-based CCPs clearing US markets or serving US persons to be registered with the CFTC and be subject to dual supervision by the CFTC and their home country regulator.

By and large, systemically important non-EU CCPs should be able to continue to provide services in the EU subject to new, albeit strict, EU requirements. However, in its current form, the EC proposal also raises a number of questions:

1) The proposal gives new discretionary powers to the EC to decide that a non-EU CCPs is of 'substantial systemic importance' and therefore should be established and authorised in the EU to provide services in the EU. Use of this discretionary ability is permitted as a last resort measure. At this stage it is unclear when and in which cases a non-EU CCPs might be deemed of 'substantial systemic importance' for the EU and, as a result, required to get established and authorised in the EU to offer clearing services in the EU. The detailed criteria to determine the 'substantial systemic importance' of non-EU CCPs will only be defined at a later stage via implementing rules.
2) It is also unclear whether this obligation for non-EU CCPs of 'substantial systemic importance' for the EU to get established and authorised in the EU to offer clearing services in the EU would be a blanket obligation covering all clearing services provided to EU clients or whether this obligation could be more granular and targeted covering a particular service, activity or class of financial instruments.
3) Where a non-EU CCPs of 'substantial systemic importance' for the EU would have to get established and authorised in the EU to offer clearing services in the EU, query whether such CCPs would still be allowed to provide euro-clearing services to non-EU clients from its third country home jurisdiction.

Finally, it remains to be seen whether the existing recognition decisions (including for US CCPs), which will have to be reviewed under the new EU regime, will be re-opened and put at risk in view of the new enhanced EU requirements or whether the introduction of the new concept of 'comparable compliance' – which would allow ESMA to determine whether the application of the

relevant third country rules is comparable to compliance with EMIR - will be sufficient to maintain the validity of those existing recognition decisions.

Conclusion

The clearing model is not broken; however, as clearing continues to expand and evolve, all market participants and regulators should continue to collaborate and achieve the objective of improving CCP resilience and therefore decreasing the probability of CCP recovery and resolution.