ISDA® Safe, Efficient Markets

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Subcommittee on Capital Markets, Securities, and Investment
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Chairman Huizenga, Ranking Member Maloney and Members of the Subcommittee, thank you for the opportunity to testify today.

On behalf of the International Swaps and Derivatives Association (ISDA)[1] and its 900 member firms across the globe, I would like to thank the subcommittee for holding this timely hearing to discuss potential adjustments to the regulatory regime for the swaps and derivatives markets. We believe it is critically important that this subcommittee look carefully at the result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and make the necessary corrections, whether it is to simplify unintended rule complexity, reduce costs, or eliminate duplication. Your leadership in examining potential ways to make regulation more effective and less costly is greatly appreciated by the business community.

In my testimony today, I will cover three areas. First, I'll provide an update on the progress made by regulators and the industry to implement derivatives market reforms. Next, I'll describe the important initiatives taken by ISDA and its members to develop mutualized solutions to facilitate implementation of the rules. Finally, I'll propose specific legislative recommendations where this subcommittee should focus its efforts. These important and necessary legislative reforms will improve the efficiency of the market, without compromising the safety and soundness of the existing regulatory framework.

Regulatory Progress Report

First, it is important to recognize that the U.S. financial system is currently stronger, better capitalized and more resilient than ever, largely due to the reforms introduced by Dodd-Frank,

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 875 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

the Basel capital rules, and the extensive efforts of market participants and regulators to implement the requirements.

For more than seven years, ISDA and its members have worked closely with the U.S. financial regulators to implement Title VII of Dodd-Frank and the related margin and capital standards. As a result, the swaps and derivatives markets have seen substantial improvements in market transparency and prudential safeguards and an overall reduction in systemic risks. It is important to stress that we are in no way advocating for a roll-back of this progress.

- Market transparency: trade data on swaps and derivatives is now required to be reported to swap data repositories and is fully accessible to regulators;
- Central counterparty clearing: 87.6% of interest rate derivatives notional traded in 2017 was cleared. 79.7% of credit default swap index traded notional was cleared over the same period;[2]
- Trading: more than half of all interest rate derivatives, or 55% of traded notional, was transacted on an electronic platform in 2017;[3]
- Capital adequacy: since 2009, globally systemically important banks (G-SIBs) have added approximately $1.77 trillion of Tier 1 capital to their balance sheets.[4] The Basel Committee has recently proposed the addition of further measures, which will result in an estimated $93.1 billion in additional capital;[5] and
- Collateral requirements: new initial margin (IM) and variation margin (VM) rules for non-cleared trades are reshaping the market, covering thousands of financial entities. According to an ISDA survey, approximately $977 billion of IM and VM was received by the 20 largest market participants for their non-cleared derivatives trades as of March 2017. It is important to keep in mind that we are only halfway through the phase-in of IM requirements, with many more buy-side participants entering into scope in 2019 and 2020.[6]

Industry Derived Solutions

As CEO of ISDA, I am pleased to report that ISDA and its members have worked hard to implement these regulations, and to provide new and innovative solutions to cut costs and increase operational efficiency in doing so. I would like to highlight a couple of examples.

I believe the ISDA Standard Initial Margin Model (SIMM) represents one of the most transformational changes ever made to industry operations. In response to new requirements to post collateral against non-cleared derivatives trades, ISDA and its members have developed a single, transparent and universally applied margin methodology that the entire market can use to

[2] *See* ISDA SwapsInfo Full Year 2017 and Fourth Quarter 2017 Review (Feb. 2018), available at https://www.isda.org/a/IhhEE/SwapsInfo-Full-Year-and-Q4-2017-Review.pdf.
[3] *See* ISDA SwapsInfo Full Year 2017 and Fourth Quarter 2017 Review (Feb. 2018), *available at* https://www.isda.org/a/IhhEE/SwapsInfo-Full-Year-and-Q4-2017-Review.pdf.
[4] S&P Global Market Intelligence
[5] *See* Basel Committee on Banking Supervision, Basel III Monitoring Report: Results of the Cumulative Quantitative Impact Study (Dec. 2017), available at https://www.bis.org/bcbs/publ/d426.pdf.
[6] *See* ISDA Margin Survey 2017 (Sept. 2017), *available at* https://www.isda.org/a/VeiDE/margin-survey-final1.pdf

calculate its IM requirements. This new solution has been shared with regulators around the globe, and marks a departure from the previous opaque, bilateral margin models, making margin calculations more predictable and reducing the potential for disputes. Probably most important is that this model is more cost-effective than the standard look up tables developed by the Basel Committee and IOSCO.

ISDA has also coordinated industry implementation of new VM requirements, and has provided standard documentation to support universal adoption. In addition, we are in the process of developing a new automated solution to support the adoption of IM requirements across the industry to provide a more cost effective and efficient solution.

ISDA also leads industry work on various legal and regulatory matters related to bank recovery and resolution, including with respect to Title II of Dodd-Frank and the EU Bank Recovery and Resolution Directive (BRRD). A key part of that work has been to publish a series of protocols that allow firms to simultaneously amend their documentation with multiple other adhering parties on a global basis. By using the ISDA Universal Resolution Stay Protocol and the Resolution Stay Jurisdictional Modular Protocol, market participants are able to amend covered master agreements, including ISDA Master Agreements, to contractually recognize stays under resolution regimes in key jurisdictions that are consistent with globally agreed principles.

This recognition addresses one of the key impediments to an effective cross-border resolution identified after the recent financial crisis. As a result of this contractual solution, well over 90% of outstanding derivatives by notional amount would be subject to temporary stays, better enabling financial regulators to perform an orderly resolution.

I should note that proposals introduced in the European Commission could compromise the global application of the Universal Resolution Stay Protocol. We are working with the U.S. Treasury, the FSB and the Bank of England to find alternatives to ensure that EU banks remain within the globally agreed resolution framework.[7]

I'd also like to highlight the work ISDA is doing to help the industry transition from the London Interbank Offered Rate (LIBOR) and other interbank offered rates, or IBORs, to transaction-based risk-free rates.

Today, the value of derivatives, bonds, loans, mortgages, and securitized products that reference an interbank rate in U.S. dollar, pound sterling, euro, Swiss franc or Japanese yen is over $370

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[7] *See* ISDA Press Release, Major Banks Agree to Sign ISDA Resolution Stay Protocol (Oct. 11, 2014), *available at* https://www.isda.org/2014/10/11/major-banks-agree-to-sign-isda-resolution-stay-protocol/; ISDA Press Release, Major Banks Sign Relaunched ISDA Resolution Stay Protocol (Nov. 12, 2015), *available at* https://www.isda.org/2015/11/12/major-banks-sign-relaunched-isda-resolution-stay-protocol/; ISDA Press Release, ISDA Launches Resolution Stay Jurisdictional Modular Protocol (May 5, 2016), *available at* https://www.isda.org/2016/05/05/isda-launches-resolution-stay-jurisdictional-modular-protocol/; ISDA Press Release, Proposed Moratoria Under the BRRD and the Impact on the Universal Stay Protocol (Sept. 28, 2017), *available at* https://www.isda.org/2017/09/28/proposed-moratoria-under-the-brrd-and-the-impact-on-the-universal-stay-protocol/.

trillion (gross notional).[8] However, a lack of actual transactions in the unsecured bank funding markets on which IBORs are based has raised concerns about the long-term viability of these rates and the systemic implications of their potential discontinuation. As a result of these concerns, regulators and market participants have been working to identify transaction-based risk-free rates as alternatives to LIBOR and other key IBORs.

Now the industry must prepare to transition from the IBORs, which are referenced in so many financial instruments, to inherently different risk-free rates within a relatively short period of time. Significantly, the identified alternative rates, which include the secured overnight financing rate (SOFR) for U.S. dollar, are overnight rates, while LIBOR and other interbank rates are quoted in various tenors, including 3, 6, and 12 month. Additionally, during the transition from the interbank rates to the alternative risk-free rates, we may see a basis between the two rates, which the market will have to address. ISDA has stepped in to help with market education and solutions to these issues.

Since 2016, ISDA has also been working with the FSB to develop contractual fallbacks that would apply if LIBOR or other key IBORs cease to exist. All of this work is vitally important to address risks associated with the market's current dependence on IBORs.[9]

These are just a few examples of the most significant industry solutions ISDA has developed in support of the regulatory reform effort. ISDA's work has provided greater legal and regulatory certainty to the various national rules, which are similar, but not identical. We have provided cost savings through the development of standardized, universal documentation and operational standards, and we are working to develop solutions for IBOR benchmark reform and yet-to-be implemented rules such as Basel III.

Regulatory Reform Recommendations

With any regulatory reform effort the size and scope of Dodd-Frank, we are bound to find areas where the anticipated outcomes and the actual results don't align, create redundancies or exceed the expected cost or scope. We believe it is vital that appropriate adjustments are made to correct the errors and provide the statutory revisions where necessary. The implementation of these

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[8] LIBOR is the predominant interest rate benchmark for USD, GBP, CHF and JPY derivatives contracts. EURIBOR is the most widely used interest rate benchmark for EUR contracts. The Market Participants Group on Reforming Interest Rate Benchmarks Final Report showed in 2014 that swaps and ETDs represent approximately 80% of LIBOR-linked contracts by outstanding notional value, and thus derivatives formed much of the early focus for global transition and reform initiatives. Going forward, this focus will broaden to include other products, such as securities, loans, ETDs and mortgages. *See* IBOR Global Benchmark Survey 2018 Transition Roadmap (Feb. 2018), available at https://www.isda.org/a/g2hEE/IBOR-Global-Transition-Roadmap-2018.pdf

[9] *See* IBOR Global Benchmark Survey 2018 Transition Roadmap (Feb. 2018), *available at* https://www.isda.org/a/g2hEE/IBOR-Global-Transition-Roadmap-2018.pdf; *see also* ISDA Press Release, ISDA, the Association of Financial Markets in Europe (AFME), International Capital Market Association (ICMA) and the Securities Industry and Financial Markets Association (SIFMA) and its asset management group (SIFMA AMG) have today launched a roadmap that highlights key challenges involved in transitioning financial market contracts and practices from interbank offered rates, or 'IBORs', to alternative risk-free rates (RFRs) (Feb. 1, 2018), *available at* https://www.isda.org/2018/02/01/isda-afme-icma-sifma-and-sifma-amg-launch-benchmark-transition-roadmap/

regulatory reforms has also revealed areas that could be improved, either through regulatory action or targeted legislation, without increasing systemic risk in U.S. financial markets. I commend the members of this subcommittee for taking the steps to make the necessary adjustments and corrections to ensure the rules are appropriately applied.

We believe that improvements can be made to the current regulatory regime by focusing on three broad themes:

I. Harmonizing Regulatory Requirements and Leveling the Playing Field for Market Participants
II. Reducing Operational Complexity and Cost
III. Providing Relief for Smaller Market Participants and End-Users

Many of the proposals under consideration today are consistent with these broad themes.

I. Harmonizing Regulatory Requirements and Leveling the Playing Field for Market Participants

One of the unique features—and great benefits—of the swaps and derivatives markets is their global nature. A global liquidity pool allows commercial end-users—which are the Main Street job creators, manufacturers and producers in the United States—to affordably protect against and hedge specific risks associated with their commercial operations.

As a result of the global reach of this business, the swaps and derivatives markets are particularly sensitive to regulatory requirements that are duplicative or contradictory or that may disadvantage one jurisdiction relative to another. This duplication may occur in both domestic and international situations. For these reasons, it is vital that both the domestic swaps regulatory frameworks among U.S. regulators, as well as the global regulatory frameworks as between the United States and foreign jurisdictions, are appropriately harmonized, that effective systems of regulatory recognition (i.e., "safe harbor", "substituted compliance" or "equivalence") are established, and that application in cross-border contexts is flexible enough to allow for resolving conflict of laws.

Let me focus on two areas where ISDA members believe harmonization and effective recognition in derivatives regulations are necessary. The first area addresses concerns surrounding the application of divergent and duplicative requirements, and the second area identifies concerns that market participants face when managing global risks.

<u>CFTC SEC Rulesets</u>

Ideally, the U.S. Commodity Futures Trading Commission (CFTC) and the U.S. Securities and Exchange Commission (SEC) would have effectively identical requirements for swaps and security-based swaps, which would allow firms to migrate between the two markets—hedging risks and providing liquidity in a cost-effective, yet well-regulated, manner. However, seven years after enactment of Dodd Frank, such an outcome has proven to be difficult to achieve in practice. As a result, ISDA instead recommends that the CFTC and SEC develop a holistic solution, such as a "safe harbor" approach.

Under such an approach, market participants that are in compliance with the CFTC's rulesets for swaps, including business conduct, capital and margin would be granted a safe harbor for the same rulesets issued by the SEC for security-based swaps, and vice-versa. If an entity were to comply with the CFTC's rules for registration as a swap dealer for their swaps activities, they would be eligible for a safe harbor from registration with the SEC for their security-based swaps activities, so long as they were fully compliant with the comparable CFTC rules.

To be clear, in either case, the derivatives activity would still be properly and thoroughly regulated; however, there would be an opportunity for a more effective and efficient oversight. This would eliminate the necessity to build out duplicative compliance systems for comparable (but not identical) rules, reduce market fragmentation and improve liquidity, while still ensuring that regulators have the transparency and tools necessary to oversee the markets.

Importantly, the safe harbor approach does not contemplate the relinquishment of the agencies' respective jurisdiction. Both the CFTC and the SEC would retain general anti-fraud and anti-manipulation enforcement authority and the respective Congressional Committees would also retain their legislative and oversight authority.[10]

Given the absence of a safe harbor regime, the impact of inconsistent rules is not insignificant, and will continue to grow. For example, the SEC's security-based swap dealer rules contain registration and compliance requirements that have no comparable requirement in the CFTC's swap dealer ruleset. Some of these add-on requirements create conflicts with laws of other countries. The disparity between the SEC's and CFTC's swap dealer rules may create artificial and arbitrary barriers to entry for non-resident dealers, limiting choice for U.S. businesses and, potentially, decreasing market liquidity.

It is important to note that the call for comparable rulesets between the CFTC's and SEC's implementation of Dodd-Frank is not a new concept; it is one that is hardwired in Dodd-Frank and was discussed during its passage. Section 712(a) of Dodd-Frank directs several areas where the CFTC and SEC must "consult and coordinate to the extent possible … for the purposes of assuring regulatory consistency and comparability, to the extent possible."

The concept of allowing products to trade interchangeably under the respective CFTC and SEC regimes is also not without precedent. In a floor colloquy following passage of Dodd-Frank, then Senate Agriculture Committee Chairwoman Lincoln provided clarity regarding Dodd-Frank's flexibility for new and novel derivatives products, noting that:

[10] Notably, the CFTC provided similar safe harbor protections in the past. In April 2013, the Commission exempted from its oversight certain energy derivatives that are regulated by FERC. *See* Final Order in Response to a Petition From Certain Independent System Operators and Regional Transmission Organizations to Exempt Specified Transactions Authorized by a Tariff or Protocol Approved by the Federal Energy Regulatory Commission or the Public Utility Commission of Texas From Certain Provisions of the Commodity Exchange Act Pursuant to the Authority Provided in the Act, 78 Fed. Reg. 19880 (Apr. 2, 2013).

> *"We strongly urge the agencies to work together under these new provisions to alleviate the ills that they themselves have identified. The agencies should make liberal use of their exemptive authorities to avoid spending taxpayer resources on legal fights over whether these novel derivative products are securities or futures, and to permit these important new products to trade in either or both a CFTC- or SEC-regulated environment."*[11]

Lastly, there have been calls for alignment from the current Administration. The U.S. Department of Treasury's October 2017 Capital Markets Report[12] called for the convergence of the SEC's and CFTC's Title VII rulesets, including a "framework of interagency substituted compliance or mutual recognition," and a call for Congress to "consider further action to achieve maximum harmonization in the regulation of swaps and security-based swaps."

One final word on this matter: while it has taken a significant amount of discussion, the U.S. and EU have found solutions to rely on one another's rules in terms of clearing and trade execution. It would be quite remarkable if we were to achieve such a determination with a foreign government, but not within our own.

Inter-affiliate Initial Margin

The second area requiring alignment of rules relates to market participants' internal management of commercial and financial risks. Specifically, ISDA supports global and domestic harmonization of the treatment of inter-affiliate transactions under non-cleared margin regulations and a universal exemption from IM requirements.

As their name implies, inter-affiliate swaps are internal risk transfers between two legally separate subsidiaries. They are commonly used by financial institutions in connection with their role as market intermediaries and by end-users to hedge capital and manage balance sheet risk.

For example, global institutions often offer swaps and derivatives to clients out of a legal entity in the local jurisdiction in which the client resides. This arrangement occurs either to comply with the local regulatory authority's requirements or to meet the needs of the client. Rather than house risk in multiple legal entities in multiple jurisdictions, these global institutions may enter into the external-facing derivative with the client, and then enter into a mirroring internal transaction to transfer the risk associated with the external transaction to a centralized foreign entity. These internal transactions allow global institutions to net down their firm-wide exposures and centrally manage their derivatives exposure.

It is important to recognize that these transactions do not create additional counterparty exposures outside of the corporate group and they do not increase interconnectedness between third parties. Rather, they are a vital risk management tool and industry best practice that help to promote safety and soundness by allowing firms to manage their risk in a centralized way that

[11] Senator Blanche Lincoln, Congressional Record Volume 156, Number 105, Page S5923 (July 15, 2010), *available at* https://www.gpo.gov/fdsys/pkg/CREC-2010-07-15/html/CREC-2010-07-15-pt1-PgS5902.htm
[12] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities, Capital Markets (October 2017).

ultimately limits overall credit exposure to third parties. Even my former colleague, Chairman Gary Gensler, explicitly recognized these benefits, noting "the risk-mitigating characteristics of inter-affiliate swaps and the sound risk management practices of corporate groups that rely on inter-affiliate swaps" when providing these swaps with an exemption from clearing requirements.

Chairman Gensler's successor, Tim Massad, further memorialized the CFTC's views regarding the importance of these transactions in its final margin rule,[13] which also provides an exemption – consistent with jurisdictions such as the EU[14] and Japan[15] – for such swaps from IM requirements.[16] The rule promulgated by the U.S. prudential regulators,[17] however, does not provide such an exemption. As a result, prudentially regulated banks have had to hold in reserve significant and often excessive amounts of capital – estimated at approximately $29 billion – against internal transactions.[18] This disparate treatment disadvantages certain firms doing business in the United States both domestically and abroad. The legislation being discussed today would remedy this disparity.

II. Reducing Operational Complexity and Cost

The second broad area in which ISDA members believe improvements can be made entails requirements that unnecessarily – and significantly -- add to the cost and complexity of using derivatives. I can think of no better example of where that problem is most apparent than the treatment of margin under the supplemental leverage ratio (SLR) requirements.

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[13] "Some have suggested that, even if inter-affiliate swaps do not increase exposure to third parties, we should require initial margin for all inter-affiliate swaps to enhance that internal risk management. But that would be a very costly and not very effective way for us as a regulator to enhance such risk management. .. if the concern is the adequacy of central risk management, then we should focus on that subject more generally. We should not attempt to address it by imposing on all inter-affiliate trades an initial margin requirement that is designed to address default risk on trading relationships between unaffiliated parties." Statement of CFTC Chairman Timothy Massad, Final Rule on Margin for Uncleared Swaps (Dec. 16, 2015), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement121615d

[14] *See* Article 11(5)-(11) EMIR.

[15] *See* Cabinet Office Ordinance on Financial Instrument Businesses, etc. (Cabinet Office Ordinance No. 52 of August 6, 2007), as amended, Article 123, paragraphs 10-11.

[16] Under the CFTC rule, firms are required to post variation margin to cover market fluctuations, but do not post initial margin, which is generally used to cover counterparty "replacement" (i.e., credit) risk.

[17] See Final Rule, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74839 (Nov. 30, 2015), available at https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf. The following U.S. prudential regulators adopted this joint rulemaking: Office of the Comptroller of the Currency, Treasury ("OCC"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); Farm Credit Administration ("FCA"); and the Federal Housing Finance Agency ("FHFA").

[18] A recent survey conducted by ISDA of the so called "Group of 14" or "G14" – the world's 14 largest derivatives dealers - found that 11 of the firms are posting inter-affiliate initial margin under the prudential regulators' margin rules at a combined total of over $29 billion.

Treatment of Margin under the SLR

The central clearing of derivatives transactions is a key objective of the G-20 derivatives reforms and a central tenet of Dodd-Frank. The leverage ratio is a non-risk based measure meant to complement risk-based bank capital requirements and is designed to act as a backstop.

In its current form, however, the leverage ratio acts to disincentivize clearing. That is because it doesn't take client margin into account when determining the exposures banks face as a result of their client clearing businesses. This perverse impact has been highlighted by numerous policy makers over the past several years. This is not a partisan issue; CFTC Chairmen under two separate administrations have raised these concerns.[19]

Properly segregated client cash collateral is not a source of leverage and risk exposure. However, the rule requires firms to include these amounts in their calculations. This approach is unreasonable as cash collateral mitigates risk. Strict rules exist to protect this collateral and ensure it cannot be used to fund the bank's own operations. Instead, it can only be used to further the customer's activities or resolve a customer default. As such, it acts to reduce the exposure related to a bank's clearing business by covering any losses that may be left by a defaulting client.

The failure of the leverage ratio to recognize the risk-mitigating effect of segregated client cash collateral could mean the amount of capital needed to support client clearing services increases considerably. The end result is that the economics of client clearing would make it extremely difficult for banks to continue to provide this service and may cause them to pull out of the market, harming liquidity and limiting opportunities for end-users. This perverse outcome runs counter to the objective set by the G-20, as implemented by Congress in Dodd-Frank, to encourage central clearing.

ISDA appreciates the steps this subcommittee has taken to recognize the risk-reducing effect of segregated client collateral in the centrally cleared derivatives market. Moreover, even end-users that are not required to clear derivatives will see the impact of the SLR in the form of rising costs for hedging as their bank counterparties will face the substantial increase in their clearing costs.

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[19] *See* CFTC Chairman J. Christopher Giancarlo, Changing Swaps Trading Liquidity, Market Fragmentation and Regulatory Comity in Post-Reform Global Swaps Markets (May 10, 2017), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22 ("Applying the SLR to clearing customer margin reflects a flawed understanding of central counterparty (CCP) clearing. Swaps clearing was adopted in the 2009 Pittsburgh Accords and Dodd-Frank Act to move customer margin off the balance sheets of bank FCMs and into CCPs. Yet applying a capital charge against that customer margin continues to treat FCMs as having retained the exposure."); *see also* CFTC Chairman Timothy Massad, Remarks of Chairman Timothy Massad before the 2016 P.R.I.M.E. Finance Annual Conference (Jan. 25, 2016), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-38 ("I am concerned, however, about how SLR impacts clearing . . .The issue here is how a clearing member's potential future exposure arising from cleared derivatives should be measured. The SLR does so through a schedule-based approach that many feel is flawed. Among other things, it doesn't take collateral held by the clearinghouse into account. The concern is that the way the SLR measures potential future exposure could have a significant, detrimental effect on clearing, and in turn, on clearinghouse resiliency")

III. Providing Relief for Smaller Market Participants and End-Users

The final area I will discuss is providing relief for smaller market participants and end-users. Here, ISDA believes Congress can have an immediate impact. We applaud the subcommittee's focus on the uneven playing field created by the credit valuation adjustment (CVA), a technical fix to the exemption for centralized treasury units (CTUs), and ending the debate over the level of the CFTC's swap dealer *de minimis* threshold.

CVA

Part of the Basel III regulatory framework, the CVA assesses a capital charge on banking organizations to address the counterparty credit risk on their uncleared derivatives transactions. Included in the CVA calculation in the United States—but not in Europe—are non-cleared derivatives transactions with end-users. The CVA requires banks to retain additional capital to protect against potential mark-to-market losses in situations where their derivatives counterparty's creditworthiness deteriorates. When banks that are subject to the CVA execute non-cleared swaps with end-users, the end-users are likely to see increased transaction costs since the banking organizations generally pass through the costs of the CVA capital charge in the form of higher pricing on their uncleared swap transactions.

A revised CVA framework was published by the Basel Committee in December 2017, but the impact will not be clear until the revisions have been thoroughly tested. ISDA remains a supporter of global consistency in the application of regulatory reforms. However, given the deficiencies in the current CVA framework, it has been a source of significant divergence across jurisdictions. The CVA capital charge increases costs on U.S. end-users that are using derivatives to hedge their risks. The value of end-user hedging practices has been recognized by Congress in enacting exemptions from clearing and margin requirements for qualifying derivatives transactions.

Applying a CVA capital charge to these end-user hedging transactions that are otherwise exempt from clearing and margin requirements undermines the goals of encouraging prudent risk management. By contrast, the Europeans recognize that end-users' activities are risk reducing, and thus exempt derivatives transactions from the CVA capital charge. The absence of a similar exemption in the United States creates disadvantages for U.S. commercial businesses, making risk management more affordable in Europe and allowing such savings to be reinvested in EU growth and passed on to EU customers.

Centralized Treasury Units (CTUs)

In 2015, Congress amended Section 2(h)(7)(D) of the Commodity Exchange Act to provide an exemption from mandatory clearing for non-financial end-users that utilize a CTU to hedge or mitigate commercial risk of the company's non-financial affiliates. This statutory exemption was intended to codify certain CFTC staff no-action relief in order provide greater certainty to end-users seeking to elect the CTU exemption from the CFTC's mandatory clearing requirements. The language that Congress enacted in amended CEA Section 2(h)(7)(D), however, is slightly different than the language in the CFTC staff no-action relief.[20] This slight difference made it unclear whether a CTU would be disqualified from electing the exemption as a result of one of the CTU's affiliates executing swaps with a financial-entity affiliate that is also part of the same corporate group but is not claiming an exemption. Essentially, these entities are being penalized simply as a result of their corporate structure and their risk management practices.

We believe that a technical difference between the language in the statute and the language in existing CFTC no-action relief should not create such a result. An amendment to the statutory text to fix this technical difference would align the language with CFTC no-action relief and allow end-users to benefit from this exemption as Congress intended.

Swap Dealer *De Minimis* Threshold

The *de minimis* threshold is an arbitrary threshold set by the CFTC without any appropriate or rigorous data collection or analysis. It was a heavily debated topic at the CFTC, and, at the time, I offered an amendment to require the Commission collect data before it made any changes to the *de minimis* threshold. The CFTC would agree to collect data, but, would not concede to require a vote before taking action. Thankfully, future Commissions took a more sensible approach and delayed the decision until all the facts were gathered. It is crucial to assess the full impact of other regulations and take into account the overall ramifications of new rules that will be coming into effect related to non-cleared margin and various Basel III related rules. We support retention of the $8 billion threshold but understand that both the CFTC and this subcommittee are assessing the appropriateness of this level.

In this regard, any modification to the threshold should be based on good data analysis as even a slight adjustment in the *de minimis* threshold could result in additional and significant compliance costs for institutions.

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As noted earlier, ISDA and its member firms support regulatory reform that mitigates systemic risk by reducing counterparty credit risk and increasing regulatory transparency. Some of the current regulatory framework for the swaps markets could, however, be simplified to harmonize requirements, reduce cost and complexity and provide relief to smaller market participants and end-users. ISDA looks forward to working with Congress and United States and international regulators to develop solutions to further these goals.

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[20] CFTC No-Action Letter 14-144, *available at* http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/14-144.pdf