Remarks by Craig Phillips, Counselor to the Secretary, on Regulatory Reform

April 30, 2018

As prepared for delivery at

ISDA'S 33rd Annual General Meeting

It is a pleasure to address this group today. Thank you for the kind introduction.

At Treasury, we recognize that derivatives and their users play an extremely important role in our financial system and economy. When used properly, derivatives allow companies to hedge and manage their risks, grow and create jobs, and provide stable prices for American consumers. These functions are crucial parts of the financial system, and proper derivatives regulations can support both economic growth and financial stability.

During this conference, you will be hearing from the CFTC. I am personally very excited to hear everything that Chairman Giancarlo has to share about their ongoing efforts to improve the regulation of derivatives. The CFTC has been an excellent partner to Treasury in evaluating current problems and potential solutions regarding derivatives regulation. The White Paper that the Chairman has released today is a critically important statement of principle of the next phase of swap market reform and steps for implementation. I will comment on that more fully in a moment. But I want to offer Chris my congratulations on this important step – timely for this gathering over these days.

For today, I wanted to cover three topics that I hope will help you understand the Administration's policy in areas of relevance to ISDA members. First, I thought it would be helpful to review where Treasury stands on completing the reports that were tasked to us under the "Core Principles" Executive Order and then highlight a few of our most relevant recommendations for this group, in particular on derivatives and clearinghouses. Second, I'll briefly describe Treasury's concerns with the European proposal regarding supervision and regulation of CCPs. Finally, I'd like to highlight efforts to manage risk from use of LIBOR in various financial instruments, including the development of and transition to an alternative reference rate.

I. Regulation Under the Core Principles

Executive Order 13772 issued by President Trump on February 3rd, 2017 directed the Treasury to identify statutes and regulations that inhibit the regulation of the U.S. financial system in a manner consistent with the Core Principles. Those Core Principles include what are essentially core values – values that align the performance of the financial system with the needs of consumers and businesses. To recap, the Core Principles include:

- Empower Americans to make independent financial decisions and informed choices
- Prevent taxpayer-funded bailouts
- Foster economic growth through vibrant financial markets with rigorous regulatory impact analysis
- Enable America's financial service companies to be competitive with foreign firms
- Advance American interests in international financial standard setting bodies
- Make regulation efficient, effective and appropriately tailored
- Restore public accountability within the regulatory agencies and rationalize the financial regulatory framework

Our work to study the changes that are needed included canvassing a large number of stakeholders, including ISDA and many of its members. Through a series of industry, academic and advocacy gatherings and bilateral meetings we have sought to understand how regulation is impacting the financial system and how best to address the goals of the Core Principles.

Our first report was released in June of last year, and covered the depository system – including banks and credit unions. Our second report was released last October, and covered capital markets regulation, including the important topic of derivatives and central clearing. Our third report, released later in October, covered the asset management and insurance industries, including retail and institutional investment products. We are also currently undertaking a final report under the Executive Order covering non-bank financials, financial technology and innovation, which will be released in the coming months.

Banking Report and Prudential Regulations

Treasury set forth in its first report recommendations to sensibly rebalance regulations in light of the significant improvement in the strength of the financial system and the economy, as well as the benefit of perspective since the Great Recession. These recommendations can better align the banking system to serve consumers and businesses in order to support their economic objectives and drive economic growth. In fact, through thoughtful reform, the soundness of the financial system can be further strengthened.

The interaction of capital and liquidity regimes was a primary focus of our recommendations. Stress-testing regimes and the implementation of gold-plated standards for our largest banks create challenges for their global competitiveness. At the same time, enhanced prudential standards for foreign banking organizations have deterred investment in the U.S. banking system. Treasury's recommendations are intended to promote the global competitiveness of our banks while at the same time encouraging further foreign investment in the U.S. banking system. Both of these aspects are aligned with promoting economic growth.

Several of our recommendations were directly focused on market regulation and balance sheet requirements:

- Rationalizing and simplifying the Volcker Rule is important to decrease regulatory burden; remove unnecessary compliance procedures; and eliminate requirements on too wide a range of banks that are not fundamentally involved in trading as a business line.
- Restrictions imposed by leveraged lending guidelines have been unnecessarily restricting access to borrowing for a wide range of established and growth companies
- Recalibrating G-SIB capital and liquidity buffers in order to create a level playing field for U.S. institutions
- Rethinking the application of the supplemental leverage ratio is important to not discourage use of firms' balance sheet in support of markets, including the treatment of U.S. Treasury holdings and initial margin for cleared derivatives.
- The initial iteration of the Fundamental Review of the Trading Book (FRTB) and Net Stable Funding Ratio (NSFR) Basel standards was widely recognized as miscalibrated. In our report, we argued that the standards should not be implemented in the U.S. until risk valuations are reworked. The Basel Committee as a whole agreed and, in December, pushed back the implementation timetable to 2022 to allow for recalibration. Treasury supports their adoption but cautions that they should be thoughtfully implemented in the U.S., as they are being introduced on top of a rigorous capital and liquidity regulatory regime. This is consistent with our view that the finalization of additional Basel reforms should be adopted in a timely and consistent manner to foster a level playing field amongst capital regimes around the world.

In aggregate, Treasury made a series of recommendations intended to enhance liquid markets and the competitiveness of the U.S. economy globally. The recommendations provided a framework for further development in our capital markets regulatory recommendations.

Capital Markets, Derivatives, and Clearinghouses

The U.S. capital markets are the largest, deepest, and most vibrant in the world and of critical importance in supporting the U.S. economy. The United States successfully derives a larger portion of business financing from its capital markets, rather than the banking system, than most other advanced economies. U.S. capital markets provide invaluable capital resources to our entrepreneurs and owners of businesses, whether they are large or small, public or private.

Certain elements of the capital markets regulatory framework are functioning well and support healthy capital formation and efficient markets. For some elements, more action is needed to guard against the risks of a future financial crisis. Other elements need better calibration and tailoring to help markets function more effectively for market participants. There are significant challenges with regulatory harmonization and efficiency, driven by a variety of factors including joint rulemaking responsibilities among agencies, overlapping mandates, and jurisdictional friction.

In order to help maintain the strength of our capital markets, we need to constantly evaluate the financial regulatory system to consider how it should evolve to continue to support our markets, facilitate investment and growth opportunities, and protect investors, while promoting a level playing field for U.S. and global firms. Treasury has identified recommendations that can better align the financial system to serve issuers, investors, and intermediaries to drive economic growth and support the Administration's other economic objectives.

I would like to touch on a few of these recommendations for regulatory reform:

- First, Treasury supports measures to promote equity capital formation for companies of all sizes, including promoting liquidity in secondary markets
- We are troubled by the decline in the number of public companies, down nearly 50% over the last 20 years. Our recommendations aim to reduce burden in public company reporting requirements; frictions in exploring public offerings and filing requirements, particularly for emerging growth companies; and to better align rules providing critical support to new issue offerings, including research services.
- Treasury supports innovative capital-raising techniques for our small businesses, which contribute significantly to job growth, including crowdfunding. The eligibility requirements, including size and time-frame, for emerging growth companies should be revisited. In addition, the accredited investor eligibility standards should be reconsidered.

- Some aspects of capital formation are impacted by secondary market considerations as well. Treasury has focused numerous recommendations on the fragmentation of secondary equity markets pricing and market making. Regulations that promote liquidity, particularly for smaller companies, can promote innovation, transparency and access.
- Second, Treasury believes that securitization, when used responsibly, provides opportunities for investors and a valuable risk management tool for lenders to diversify their risk concentration and exposure.
  - Post-crisis reforms went too far toward discouraging securitization across multiple asset classes. For example, regulations on bank capital, liquidity, risk retention, and disclosures add unnecessary cost and complexity to the securitization market and apply broadly across securitized product classes, irrespective of their differences and history of performance. The result has been to dampen the attractiveness of securitization, potentially cutting off or raising the cost of credit to corporate and retail consumers.
  - In our report, we recommended several measures to encourage consumer and business lending through the promotion of markets for quality securitized products:
    - Capital that banks must hold against securitized exposures (compared to comparable loan exposures) and related liquidity requirements should be rationalized.
    - Disclosure requirements should be maintained at robust levels, but certain existing disclosure requirements that deter greater use of public issuance could be reduced or streamlined.
    - A simpler regulatory regime should be implemented across all securitized asset classes, which should expand qualifying risk retention underwriting exemptions across eligible asset classes based on the unique characteristics of each asset class.

Of interest to this group is of course recommendations concerning derivatives markets and central clearing. The regulatory environment for this increasingly complex and global market has included evolving CFTC and SEC oversight of the over-the-counter derivatives market and its participants, as well as implementation of swap clearing, margining and data reporting requirements, increased regulation of derivative clearinghouses, the framework for swap data repositories and the expansion of prudential regulation of related capital and liquidity standards.

In our discussions with market participants, by and large we found widespread support—at least at a high level—for these key post-crisis OTC derivatives reforms, including especially for central clearing. But as the old saying goes, the devil is in the details. Treasury found many areas where post-crisis OTC derivatives rules needed better calibration. While many of the issues are quite technical in nature, I will highlight several recommendations from our Report:

- First, CFTC and SEC should undertake a joint effort to review their respective rulemakings in each key Title VII reform area. The goal should be to more fully harmonize these rules and eliminate redundancies and distortive market effects and inconsistent compliance burdens.
- Second, while Treasury is supportive of central clearing, not all swaps can be cleared. Therefore, it is important that uncleared swaps are treated appropriately, which may involve recalibrating required initial margin to be more tailored to the relevant risks. The nature of margin requirements between affiliates should be revisited and the SEC should re-propose its rules for uncleared security-based swaps in a manner that is aligned with the margin rules of the CFTC.
    - Third, required capital should be based on a reasonable measure of a derivative's risk. The current exposure method (or CEM), which is used to measure derivatives exposures, is insensitive to risk and results in higher leverage ratio capital requirements for certain derivatives products (including exchange-traded derivatives) relative to risk-based measures. The CEM model, for example, requires options contracts to be sized on their notional face value rather than allowing for a delta or risk adjustment. While the Basel Committee has developed the Standardized Approach for Counterparty Credit Risk (or SA-CCR) to address some of these issues, its implementation has been delayed and it may need calibration to appropriately measure derivatives risks.
    - Fourth, we recognize that these markets are global in nature, and are concerned about the inconsistent implementation of post-crisis regulatory reforms across different jurisdictions resulting in needless market fragmentation. The CFTC and the SEC should continue to work with non-U.S. regulatory authorities to ensure that swaps and security-based swaps rules across jurisdictions are compatible to the extent possible. Cross-border cooperation should include meaningful substituted compliance programs to minimize redundancies and conflicts. And the CFTC and the SEC should reconsider their approaches to swaps and security-based swaps transactions involving non-U.S. persons that are arranged, negotiated, or executed by personnel in the United States so as not to unduly or arbitrarily fragment market activity. Treasury believes these objectives are best achieved through appropriate bilateral and multilateral regulatory cooperation.

Post crisis OTC derivatives reforms have also had significant implications for central clearinghouses, or CCPs. To be sure, U.S. clearinghouses have for decades handled tremendous transactional volumes and are highly interconnected to other U.S. financial institutions. Over the last decade, Dodd-Frank's swaps clearing mandate and other regulations have pushed even more trading activity into clearinghouses. Now more than ever, potential distress at or failure of one of these clearinghouse raises significant systemic risk concerns.

Because of the central role these clearinghouses play in the financial system, continuity of market functioning is a critical priority. Accordingly, we believe the primary focus of recovery and resolution efforts must be the recovery of the CCP, so that the CCP can continue to provide critical services to financial markets, and the matched book of the failing CCP can be preserved. Resolution, including cessation of market activity and winding down of operations, should be considered a last resort.

While certain clearinghouses have been designated as "systematically important" by FSOC, the regulatory oversight and resolution regime for these institutions remains insufficient. It is unclear how well tools developed in the context of other financial institutions such as banks will work for clearinghouses. More needs to be done to address these risks, and in our report we recommended a series of practical and concrete steps to do so. We are engaging with regulatory agencies on several fronts, specifically:

- - Clearinghouses need to be subjected to additional supervisory stress tests that incorporate additional products, different stress scenarios, and operational and cyber risks. The CFTC has made helpful progress in this regard, such as including liquidity risk in their stress tests for the first time last fall, but additional steps are needed.
  - Clearinghouses should have viable recovery and wind-down plans. It is critical that the FDIC and the CFTC, within their respective areas of expertise, continue to coordinate on the development of these plans as well as their own preparations for such contingencies.
  - More attention is needed on risks presented by non-default scenarios, such as operational and cyber risks. These scenarios may require unique approaches and tools, and should not be under-estimated.
  - Consideration should be given to the potential risks that may be posed by the lack of Federal Reserve Bank deposit account access for certain FMUs with significant shares of U.S. clearing business, and an appropriate way to address any such risks.
  - Finally, I want to emphasize the importance of international coordination though crisis management groups, where domestic and foreign regulators share relevant data and consider challenges that may arise during the cross-border resolution of a clearinghouse.

Following the publication of these reports, we have continued to press these banking and capital markets recommendations and other recommendations with regulatory agencies and Congress. In addition, we are urging regulators in other jurisdictions to adopt a similar approach with respect to compatible regulatory regimes and outcomes-based substituted compliance or equivalency determinations. We are confident that many of these important changes can and will be implemented, but it is a process that will take time. Fortunately, we have thoughtful and committed leadership at our regulatory agency partners who are committed to sensibly revising regulations for our banking and capital markets, to better align them with the core principles of the Executive Order.

II. European CCP Proposal

Last year, the EC and the ECB issued proposals that would bolster EU-level supervisory and regulatory authority over both European and non-EU CCPs. These proposals, if approved, would give EU authorities broad powers to determine to categorize or "tier" a third-country CCP based on systemic importance. The tier would, in turn, determine application of the EU rulebook to the CCP and whether the CCP must relocate to the EU in order to provide services to EU firms.

These proposals appear motivated by Brexit and aimed at London domiciled clearing of euro-denominated swaps. However, if adopted, the regulatory framework could also affect clearinghouses in the U.S., since both the U.S. and UK are third countries. Accordingly, we have significant concerns with the proposal. The proposal includes unnecessary and redundant recognition requirements that may jeopardize the CFTC-EC CCP equivalence arrangement negotiated in 2016. It could also significantly increase costs for firms, which could reduce incentives for central clearing. Finally, a relocation policy for clearinghouses could fragment global markets and diminish liquidity.

The United States is supportive of finding a constructive and lasting solution on the issue of cross-border CCP supervision, and recognizes the objectives of enhancing market supervision and financial stability in the European Union. We would like clarity on the criteria and timeline of the proposals for cross-border CCP supervision, and we encourage a proactive and constructive dialogue between the EU and United States on effective and efficient supervision of systemically important CCPs. Other models of supervisory cooperation could address the EU concerns with lower cost and less financial stability risk.

III. LIBOR and Alternative Reference Rates

Finally, I'd like to turn to the matter of LIBOR and its widespread use in the financial system. Despite LIBOR's ubiquity and the roughly $200 trillion of gross notional exposure to LIBOR through derivatives and other financial instruments, there are important questions about its future. Market activity underlying LIBOR submissions has substantially declined because of the reduction in the use of short-term unsecured funding by banks. For even the most widely referenced tenor, 3 month USD LIBOR, underlying transaction volume is estimated to be approximately $500 million per day, and as a result, only about one quarter of submissions by LIBOR panel banks are based on actual transactions. Because of this lack of transactions, and given the history of LIBOR's manipulation leading up to the financial crisis, it should come as no surprise that many panel banks are questioning whether they should continue LIBOR submissions. Two banks have ceased contributions in recent years, and the U.K. Financial Conduct Authority (FCA), the regulator of LIBOR, has sought voluntary agreements with others to continue publishing through the end of 2021, after which the FCA would not persuade or compel banks to continue submitting.

Against this backdrop, in 2014 the Federal Reserve convened the Alternative Reference Rates Committee (or ARRC), whose mission is to identify and promote market adoption of both alternatives to LIBOR as well as best practices for contract robustness. Treasury is an ex-officio member of the ARRC, and fully supports its work. Last year the ARRC selected the Secured Overnight Financing Rate (or SOFR), which is an overnight Treasury repo based rate, as its preferred alternative to LIBOR. Earlier this month, the Federal Reserve Bank of New York, in cooperation with the Office of Financial Research, began publishing SOFR. In contrast to the roughly $500 million of transactions underlying LIBOR, there are about $750 billion of transactions underlying SOFR. I want to emphasize two points here:

- First, the goal is a market-led transition. This issue affects a broad range of market participants, and we are looking to the market to coalesce around constructive and workable solutions. The ARRC includes banks, central counterparties, asset managers, insurance companies, corporates, government-sponsored enterprises, and trade associations like ISDA. We hope these participants can come together in the interest of the financial system as a whole.
- Second, the sooner market participants act, the easier the transition will be. An estimated 82% of LIBOR exposures will mature or roll off by the end of 2021. Every day new contracts are written against LIBOR, and action now to ensure they have appropriate fallbacks, or to use an alternative rate altogether, will be much easier than trying to resolve disputes during

a potential disruption in LIBOR down the road, which could coincide with a period of market stress.

Conclusion

In conclusion, I would like to highlight Treasury's support for Chairman Giancarlo's White Paper on Swap Regulation Version 2.0 – of course you will hear from him momentarily.

- It is spot-on in supporting the swap market reforms incorporated in Title VII of the Dodd-Frank Act, as we truly believe we can tailor a regulatory regime under that legislation that maintains market "vibrancy, diversity and resilience"
- The Chairman rightly focuses on the importance of regulation of CCPs and most importantly the creation of a predictable, sound regime for the potential of recovery, and if necessary, resolution. Many steps have been taken – but more remain. Treasury intends to work steadfastly with the CFTC, the FDIC, the Federal Reserve Board and international parties on this important mission.
- Swap Data reporting was a critical objective of Dodd-Frank, but our global implementation requires adjustment. This should rightly incorporate the best technological approaches. The Chairman rightly is redirecting efforts on this front.
- Any rule set for the regulation of derivatives and clearing will not be effective without proper calibration of capital and liquidity standards. I have already commented on this today and strongly endorse the efforts of the CFTC and the SEC to work in collaboration with the prudential regulators, here and abroad, to complete a critical assessment as to how we can both maintain safety and soundness but preserve market liquidity.
- Finally – investors are really important. Many such end-users, as investors are referred to in the Dodd-Frank Act, are here today. Treasury is very concerned about market structure considerations, treatment of end users and the identification of the appropriate thresholds in both trading and clearing.

I congratulate Chairman Giancarlo on his important policy statement and look forward to hearing from him now, as I am sure everyone does.

I thank you for your time today. I hope the remarks have provided some additional insight into the Administration's view of regulatory reform for our banking and capital markets. The alignment of regulatory policies with sound economic growth is an achievable and viable goal.