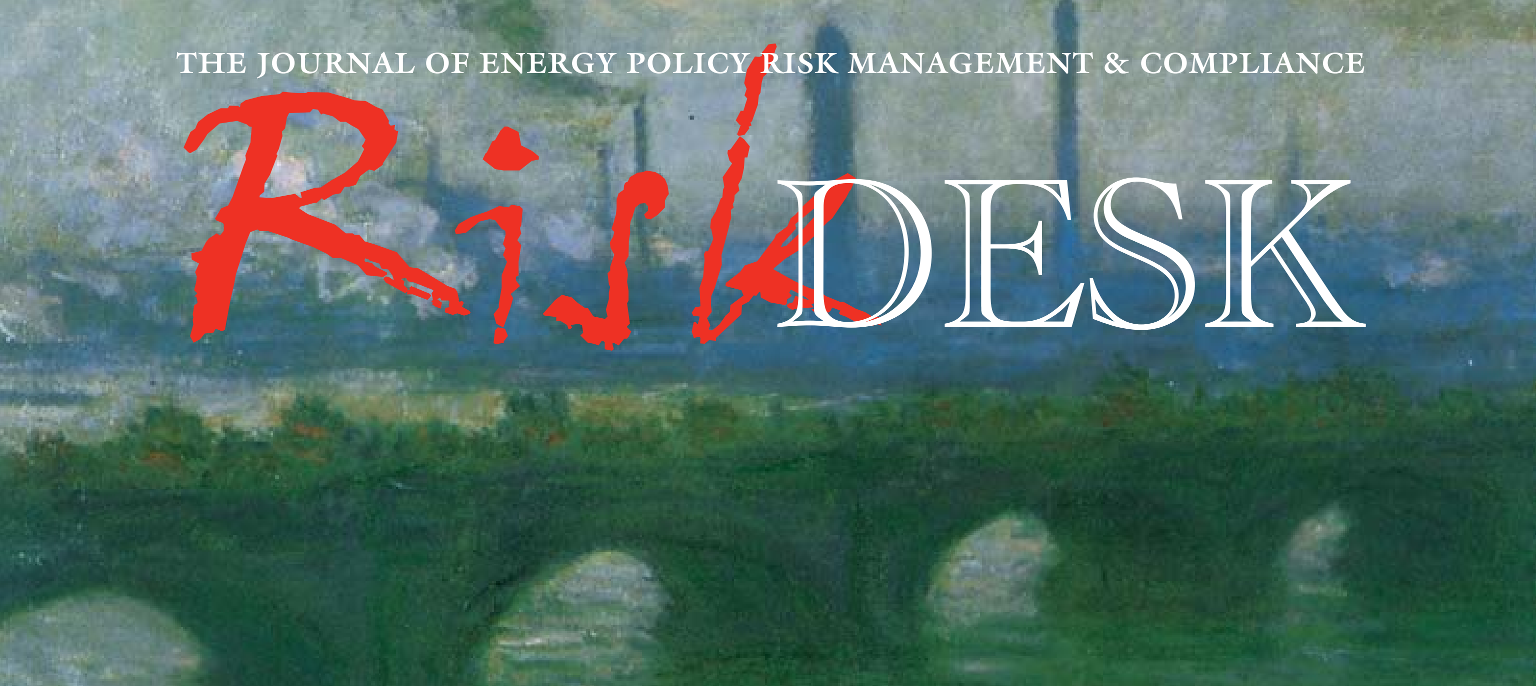
THE JOURNAL OF ENERGY POLICY RISK MANAGEMENT & COMPLIANCE

Risk DESK

SPECIAL EDITION

swaps market reform ver.2

reform package rules to hit the streets before July - Giancarlo

Last time, we reported that swap market reform was coming soon and possibly even sooner than anybody might have anticipated. This morning, CFTC Chairman Chris Giancarlo will deliver a speech to a packed, annual ISDA event in Florida at which he offers up his new vision for sweeping swap market reform, including lots of details and better-than-approximate timelines.

All these new swap reform details and much, much, more can be found in a new 90-plus page white paper written by Giancarlo and CFTC chief economist Bruce Tuckman, to be released today.

The Risk Desk was given access to the white paper in advance of today's release. The new white paper, "**Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps**," largely follows his original game plan that he detailed in his previous 2015 white paper on the same subject. The big difference this time, is that his current thoughts and views on the swaps market can now be supported by several years worth of actual market data "plus the insights he's gained as a commissioner and chairman over the past four years, into the realities of the regulatory-administrative and political processes," a source says.

While the current paper is a much longer read than the first version (2015), if you stacked up the specific reforms and changes identified in each paper next to each other, you'd find that Version 2 is actually a bit more streamlined. That is, it targets swap market reform with a scalpel and not a meat cleaver. Mostly.

This lengthy, at times wonky white paper is also fundamentally a bit more realistic or perhaps clear-eyed in its goals. Quite a few issues that were discussed in the first white paper are now on the cutting room floor, because time and circumstance proved them otherwise unnecessary. That said, the new playbook is almost 100 pages long. Where old concerns may have died, new issues have also emerged in the past few years. The authors cover this, too.

In terms of timelines, we're told that all of the CFTC-specific reforms will be powered through the mill in about as close to federal agency "real time" as can be managed. All reforms discussed in the white paper that may involve some level of rule- or policy-syncing with other regulatory agencies (US or foreign) we were told will be engaged this year for sure, but no

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Swaps Regulation Version 2.0

An Assessment of the Current Implementation of Reform and Proposals for Next Steps

White Paper

J. Christopher Giancarlo, Chairman,
and
Bruce Tuckman, Chief Economist,
U.S. Commodity Futures Trading Commission

April 26, 2018

promises on when rules or policy reform will be finalized.

So, what's first? The big kahuna, a source tells us, a rewrite of SEF execution rules will be coming out before July (2018). Needless to say, the agency will finally zero in on Congress's original intent, that is, allowing swaps to be executed on regulated platforms called swap execution facilities (SEFs) and executed by "any means of interstate commerce." As Giancarlo correctly described it in his previous white paper, the CFTC incorrectly implemented this corner of swaps market reform. He says the agency attempted to "re-engineer much of the market structure of swaps execution by limiting methods of swaps execution in contravention of express congressional intent. The CFTC grafted into its SEF rules several market practices from highly liquid futures markets that are antithetical to episodically liquid swaps trading. It interpreted core principles in ways that are not conducive to environments in which swaps liquidity is formed and price discovery is conducted..."

Our first prediction is that the SEF market is going to become a lot more crowded in the coming months. But, we're getting ahead of ourselves. In the advance time we were allowed to asses this sweeping white paper, several things jumped out at us.

Unlike his first white paper, which was largely a solo effort, this time Giancarlo has a formal co-author and seemingly went to great lengths to research and assess this galaxy of past market reforms, using source material well beyond the bounds of 21st Street NW. From the executive summary: "This White Paper analyzes the range of academic research, market activity and regulatory experience with the CFTC's current implementation of swaps reform." It also attempts to "to address flaws, recalibrate imprecision and optimize measures in the CFTC's initial implementation of swaps market reform."

As he's said many times in the past, Giancarlo reaffirms that he is "a public supporter of the swaps market reforms passed by the U.S. Congress in Title VII of the Dodd-Frank Act of 2010," and that his only beef is with the way the CFTC has implemented that act. And that, in so many words, defines his path forward.

Swaps Clearing—The paper describes it as "probably the most far-reaching and consequential" Dodd-Frank reform. The authors view clearing as "highly successful," but then describes three major challenges associated with clearing: 1) ensuring CCPs are "safe and sound" under extreme but plausible conditions; 2) recovery plans when default and losses occur; and 3) resolution by government authorities when recovery plans prove inadequate in practice.

Swaps Reporting Rules—The paper argues that Dodd-Frank "got much right in requiring that swaps trades be reported to swap data repositories," but that a decade after the financial crisis, "SDRs still cannot provide regulators with a complete and accurate picture of counterparty credit risk in global swaps markets." It attributes this shortcoming to "insufficient technological detail and specification" by regulators in setting standards for data reporting.

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In effect, it faults regulators for not being prescriptive enough. No irony lost on that one. We reported for several years on the trials and tribulations of CFTC tech wizards as they attempted to manage data standardization for an army of private sector platforms and counterparties, vendors and exchanges. The bottom line has been that the agency was and is simply out of its league on this massive data standardization chore. The white paper doesn't exactly put it that way, but this agency's short suit is well-known in the market. And now we see Congress, in its infinite wisdom, has cut the agency's budget. The importance of policy reform aside for a moment, we'd wager that the agency's most pressing issue is covering its hulking deficit in modern technology and tech sophistication. Since everything about Dodd-Frank in some fashion circles back to reporting something to somebody, this complex issue of reporting rules and reporting requirements may require the cleaver treatment, to make it all actually function.

Swap Execution Rules—By contrast, the white paper directly faults the CFTC for imposing "arbitrary and prescriptive requirements," such as the requirement to use either an electronic order book or obtain three quotes from unaffiliated participants (the request-for-quote system). These prescriptive requirements "disincentivize" the use of SEFs, thus reducing liquidity formation from taking place on such platforms. The authors propose removing these "ad hoc constraints on methods of execution and other inapposite forms taken from futures markets." The paper also advocates expanding the category of swaps subject to the Trade Execution Requirement to include all swaps subject to the CFTC's clearing mandate, presumably to provide more business for SEFs. Good idea.

Swap Dealer Capital—This somewhat wonky section of the paper urges regulators to rely more heavily on internal risk models used by banks, recognize netting and repeats past critiques of the Supplementary Leverage Ratio as it is applied to margin for swaps. Heady stuff for sure.

End-user Exception—We run a bit of this section later in our special edition. The energy sector will cheer this comprehensive and necessary element of swaps reform and one day soon maybe we can do away with many of those pesky no-action letters. In this section, the authors advocate exempting smaller financial end users from clearing and margin requirements through a generous swaps exposure threshold, for the same reasons that commercial end users are exempt. Larger financial end users, on the other hand, that can well be sources of systemic risk, should remain subject to the clearing and uncleared margin requirements, the authors say. Makes sense to us. It also urges a far less prescriptive approach for setting uncleared margin to encourage "sound and innovative risk management," and to avoid "model herding," whereby everyone follows the same one-size-fits-all margin model developed by regulators. It's clear to us this section was given special attention, by a couple guys who spent most of their adult lives working in the private sector. This reform for end-users will have a huge impact.

That's the 12,000-foot view.

As for the details, we invited a couple colleagues to join us in sifting through as much of the 29,000 words found within this white paper as could be managed in short order. Some of the comments got a bit snarky at times. "I'm allowed," one reviewer said, "I've waited a decade for this to happen … " We can all agree on that point, anyway.

The opening pages managed to provoke one of our reviewers. His ideal Republican sensibilities were singed, he tells us. "Page two just reaffirms the *Liberal Narrative* (his emphasis) of the 2008 financial crisis, when the authors say that, "Over-the-counter (OTC) derivatives contributed directly to the financial crisis through American International Group's (AIG) writing of credit default swaps (CDS) protection on mortgage products – a substantial part of AIG's failure – and through synthetic mortgage collateralized debt obligations (CDOs), which had made their way onto bank balance sheets. Perhaps most important, however, was the lack of reliable information about OTC derivatives positions contributing to the "fog of war." Very simply, government authorities did not have the data to accurately assess the implication of the failures of Bear Stearns." Our reviewer suggests that this paragraph "could have been written by Gensler himself." And this wasn't meant to be kind. "Much has been written to dispute this narrative," our reviewer adds, "and in any case, in a footnote, the white paper states: "In contrast to exchange-traded derivatives such as listed futures and options, which performed reliably and well throughout the 2008 financial crisis." So, if futures performed so well, why does the chairman regularly criticize the Dodd-Frank implementation for imposing a "futures model" on OTC derivatives?"

OK, so this is splitting hairs just a bit. Yes, the chairman does often criticize the avid use of a futures market model on OTC derivatives by past chairmen, but as the paper points out, the results over time have been both good and bad. The point of the paper, the authors state, is to explicitly exercise the bad and save the pearls.

The same reviewer notes that the authors can take credit for recognizing that regulatory competition is a good thing. "Throughout the Gensler-Massad era, we constantly heard that we as a market needed such a prescriptive (Dodd-Frank) framework because otherwise everyone in the financial world, including global regulators, "would engage in a race to the bottom." That is, the system with the weakest regulatory framework would win out." The white paper, our reviewer says, adopts a far more realistic view:

"Trading counterparties seek neither the least nor the most regulated

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Cover painting is by Claude Monet, *Waterloo Bridge, Overcast Weather,* 1899.

marketplaces, but marketplaces that have the right balance of sensible, objective and well-maintained regulation – in other words: good software. It is in the interest of the United States to achieve such balance in swaps market regulation."

We can all agree with this fresh, change of view.

While Chairman Giancarlo has often voiced the benefits of central clearing over the past few years, the paper also recognizes that central clearing is hardly a panacea. Another reviewer notes that the paper does a decent job in highlighting some of the challenges associated with central clearing, which has otherwise been the subject of some critical discussion in recent years. The most immediate challenge is described on page 9: "The risk to the CCP, therefore, is that one of the counterparties loses value on its position and defaults, before having made its variation margin payment for the day Yes, that is the first challenge, and that challenge is magnified in an environment like we had in 2008 when the market and its participants were in a state of deep stress," our reviewer notes. And given the central nature of clearing, "I was surprised that more time, more details and more solutions weren't devoted to this aspect of swaps reform. At times it's almost vague. The paper implicitly recognizes this is a big issue, but doesn't approach the matter directly. Risk relocation has not solved the problem of risk mitigation. Is the preservation of the central clearing function all important, at the expense of the financial system in the whole? CCPs create a real problem, in high-stress times the margin calls are killer … and at the worst possible time."

On page 11, the paper goes on to say, "despite best efforts to ensure that clearing members are creditworthy and that initial margin is adequate, there is always the possibility that combinations of clearing member failures and adverse market moves in excess of margin would leave a CCP with losses." At that point, the CCP has to rely on its guaranty fund and assessments on its clearing members to meet its obligations and stay afloat. But on page 12, the paper observes, "Some have questioned whether clearing members will honor assessments in the midst of a financial crisis, after the CCP has gone through all of its prefunded resources." Then on page 13, we read with some alarm, that these prefunded and additional resources may not be available when needed:

"CFTC regulations require that CCPs hold margin in safe and liquid assets. These requirements restrict both the securities that members post as margin and the CCPs' investments of cash posted as margin. Nevertheless, since the default of one or more clearing members may very well be part of a larger financial crisis, a CCP with a sufficient amount of resources to meet its obligations might have difficulty converting those resources into cash as quickly as needed."

Exactly. But there's more. "For example, on the next page, the paper con-

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firms another less-than-positive attribute of mandatory central clearing, which the authors aptly characterize as an "unsettled policy question."

"The CCP industry is extremely concentrated, which itself presents certain risks to the financial system."

Concentrated, indeed. Which is a red flag we'd say if you recall that the central model was premised on the fact that the OTC derivatives market was hopelessly "interconnected" with the financial markets.

Further on (page 16) the authors actually present a somewhat reassuring tone: "In any case, correlated defaults and network effects are active areas of regulation and research that deserve continued attention. Meanwhile, near-term comfort may be derived from the CFTC's 2016 stress tests, which showed that clearing members with significant losses at one CCP in a given stress scenario did not tend to have significant stress losses at other CCPs in that same scenario."

The paper is correct in pointing out that the central clearing model needs to be assessed and reassessed and studied often. Our reviewer clearly isn't convinced on the long-term value or market stability to "relocating risk" to a central clearing market platform, and as such, faults the paper for not providing more detailed solutions to cover the sort of extreme scenarios that might cripple multiple CCPs at the same time. Well, maybe. Perhaps co-author Tuckman can launch an ongoing study on the subject. Perhaps he can solve the Russian problem too, and figure out how to make a perfect fake burger.

One reviewer, often critical of inconsistent policy approaches he's seen over the years, notes that the paper at times "exhibits an inconsistent approach to solving problems in this sector." It's an interesting point, albeit a bit snarky, but given that the enormity of Dodd-Frank rules were crafted and implemented in a vacuum-like setting, consistency of reform implementation will always be a near impossible task we think. Where Chairman Giancarlo typically favors a non-prescriptive, principles-based approach to swap trading rules, "he favors the opposite when it comes to data reporting for SDRs." In this case, the reviewer was talking about the chairman's preference for DLT, now and going forward. "By contrast, when it comes to swap execution rules, Giancarlo favors a principles-based approach: "Congress chose not to mandate that SEFs utilize any particular method of trading or execution. Instead, Congress defined the term SEF to mean a 'trading system or platform in which multiple participants have the ability to execute or trade swaps … through any means of interstate commerce." Again, splitting hairs. Dodd-Frank was largely a mash-up and thus solutions to fix it should rightly be what works best, rather than a strict adherence to form. Our two-cents.

"Now he may be right with respect to swap data, since one of the functions of government is to promote weights and measures, and data reporting may be one area that requires standardization imposed or encouraged by government, that is "standardized definitions and reporting formats," as Giancarlo notes in the paper. "But elsewhere, with respect to swap execution rules, and with respect to margin setting uncleared swaps, he favors rulemaking by "organic growth" that "takes into consideration the vastly different characteristics of swaps trading, including its more variable and episodic liquidity."

So, for swaps reporting, the authors advocate for the CFTC to prescribe the methodology, but for swap execution, they favor eliminating prescriptive trading requirements and allowing flexible means of execution. Further, the authors generally favor "non-prescriptive regulatory standard" for swap margins that allows "market participants to come up with appropriate, business-specific models."

While clearly drafted by a couple pro-market Republicans, we see the paper's less-strict adherence to form and politics as a strength, not a weakness, as our reviewer seems to suggest. As they say, 'Different strokes for different, er, rules' (apologies

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to Sly and the Family Stone). That the authors are confidently pursuing such a varied strategy to "get it right," we rather think this new playbook should be called Version 7, not Version 2, of swap market reform. We think this approach will eventually be viewed as enabling this commission to leap-frog a lot of wasted time and effort in this much-needed reform effort.

From the section on Trade Execution Requirements: This White Paper posits that the CFTC's MAT, mandatory Order Book and prescriptive trade execution requirements have not met Congressional goals. These requirements have stunted swaps trading on SEFs in two ways: first, by unduly limiting what it means for a swap to be "made available to trade" – unnecessarily restricting the swap transactions that are required to be traded on SEFs; and second, by reducing the execution methods for swaps subject to the Trade Execution Requirement. The adverse consequences have been to fragment global trading liquidity, increase market liquidity risk, restrict technology innovation, and incentivize a significant amount of price discovery and liquidity formation to take place off-SEF. To address these deficiencies, this paper proposes eliminating the requirement that SEFs maintain an Order Book and also permitting SEFs to offer any means of interstate commerce for the trading or execution of swaps subject to the Trade Execution Requirement.

From the section on END USER EXCEPTIONs: This section concludes that the swaps regulatory framework can be improved in several ways, though many changes will require international coordination. In particular, recommendations include the following:

The CFTC should continue to provide relief to small banks from clearing requirements by codifying existing no-action relief and considering incremental regulatory changes;

"Material swaps exposure" thresholds, below which entities are excepted from uncleared margin requirements, should be reworked, measured in units more meaningful than notional amounts, and should apply to variation margin as well as initial margin;

A material swaps exposure threshold should be applied against the clearing requirement, as well; and

Rules governing uncleared initial margin calculations should be much less prescriptive and should not be biased in favor of cleared products.

"This paper argues that smaller financial end users should be excepted from the requirements through a material swaps exposure threshold, for the same reasons that commercial end users are exempt. Larger financial end users, however, that may well be sources of systemic risk, should be subject to the clearing and uncleared margin requirements. This paper also argues, along the lines of other issues in this White Paper, that uncleared margin rules can – and should – achieve their objectives without being as prescriptive as under current law. A less prescriptive approach would encourage sound and innovative risk management and would be less likely to encourage model herding, which is itself a source of systemic risk."

We recommend you have a look. By the time you read this, the white paper should be posted on the CFTC website. Giancarlo is pedal to the metal on this one and he is committed to seeing it through, even if this huge basket of swap reforms, and all the KISS stuff takes him past his expiration date of April 2019. Sources tell us that he has already assured the WH he will finish all that he's started, in any case.

We would like to thank former CFTC counsels Bob Zwirb and Jack Benny (not his real name), and industry economist Zane K. (also not his real name), for advice, counsel and oversight.