

Neal Blinde Executive Vice President and Treasurer 301 S College St, 40<sup>th</sup> Floor Charlotte, NC 28202

March 15, 2019

Via Electronic Submission

Legislative and Regulatory Activities Division Office of the Comptroller of the Currency Attn: Docket ID OCC-2018-0030 400 7th Street SW, Suite 3E-218 Washington, D.C. 20219

Ann E. Misback Secretary Attn: Docket No. R-1629 and RIN 7100-AF22 Board of Governors of the Federal Reserve System 20th Street & Constitution Avenue, N.W. Washington, D.C. 20551

Robert E. Feldman Executive Secretary Attn: Comments, RIN 3064-AE80 Federal Deposit Insurance Corporation 550 17th Street, N.W. Washington, D.C. 20429

# Re: Notice of Proposed Rulemaking - Standardized Approach for Calculating the Exposure Amount of Derivative Contracts

Ladies and Gentlemen,

Wells Fargo & Company, together with its affiliates and subsidiaries (collectively, "Wells Fargo" or "we"), appreciates the opportunity to comment on the joint notice of proposed rulemaking entitled *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts* (the "Proposal").<sup>1</sup> Wells Fargo is a diversified, community-based financial services company with \$1.9 trillion in assets and approximately 259,000 team members. We provide banking, investment and mortgage products and services, as well as consumer and commercial finance.

<sup>1</sup> 83 Fed. Reg. 64660 (Dec. 17, 2018).



We appreciate the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the "Agencies") efforts to introduce a new approach, the standardized approach for counterparty credit risk ("SA-CCR"), for calculating the exposure amount of derivatives. The approach would be used by Advanced Approaches<sup>2</sup> banks, including Wells Fargo, in certain capital and other regulatory calculations and would be optional for non-Advanced Approaches banks. We support the SA-CCR's objectives to improve the risk-sensitivity and calibration relative to the current exposure method ("CEM") in the measurement of counterparty credit risk. Consistent with those objectives, our letter provides targeted commentary on key issues of importance to Wells Fargo.

We also participated in and support the comment letters submitted by the Financial Services Forum ("FSF") and the International Swaps and Derivatives Association ("ISDA") on the Proposal. Specifically, we emphasize FSF's and ISDA's concerns regarding the Proposal's impact on commercial end-users, the need to assess the calibration of SA-CCR, and timing of implementation in the broader context of the U.S. adoption of the Final Basel III package of reforms.

We continue to support a comprehensive approach to the U.S. implementation of the Final Basel III package of reforms in order to avoid potential incongruities and to ensure the overall calibration of capital requirements is appropriate. In the context of the Proposal, the Agencies justified the inclusion of the 1.4 alpha factor to ensure SA-CCR calibration is not lower than the internal models method ("IMM").<sup>3</sup> The Federal Reserve Board has also indicated the possibility of eliminating the Advanced Approaches in favor of a more risk sensitive standardized approach upon implementation of the Final Basel III package.<sup>4</sup> Under this scenario, the 1.4 alpha factor may no longer be justified based upon the rationale in the Proposal; however, it is not clear whether SA-CCR would be recalibrated upon adoption of the Final Basel III package. To avoid these potential incongruities and to ensure the overall calibration of regulatory capital requirements is appropriate, we believe the Agencies should delay the mandatory effective date of SA-CCR to align with the remainder of the Final Basel III package of reforms and remain open to recalibration of any elements of the package that are finalized prior to completing a comprehensive assessment of the reforms in their entirety.

Our specific comments address key topics in the Proposal that we believe warrant modification or clarification in the final rule. First, recalibration of the proposed SA-CCR methodology is needed to bring coherence to the regulatory framework and ensure commercial end-users continue to have the ability to hedge commercial risks. Second, the Proposal creates unnecessary burden and inefficiency in calculating exposure amounts for derivatives

<sup>&</sup>lt;sup>2</sup> Subpart E of 12 C.F.R. Part 3 (OCC), 12 C.F.R. Part 217 (FRB), and 12 C.F.R. Part 324 (FDIC), collectively the Advanced Approaches, is currently applicable to banking organizations with \$250 billion or more in total consolidated assets or \$10 billion or more in total on-balance sheet foreign exposure, together with depository institution subsidiaries of banking organizations meeting those thresholds. Separately, the Agencies have published a proposed rule that would generally require the Advanced Approaches for U.S. global systemically important bank holding companies ("G-SIBs"), and banking organizations with \$700 billion or more in total consolidated assets, or \$75 billion or more in cross-jurisdictional activity. 83 Fed. Reg. 66024 (Dec. 21, 2018).
<sup>3</sup> 83 Fed Reg. 64,666 (Dec. 17, 2018) ("The alpha factor was included in the Basel Committee standard under the view that a standardized approach, such as SA–CCR, should not produce lower exposure amounts than a modelled approach.").

<sup>&</sup>lt;sup>4</sup> Randal K. Quarles, Vice Chairman for Supervision, Bd. of Governors of the Fed. Reserve Sys., Early Observations on Improving the Effectiveness of Post-Crisis Regulation (Jan. 19, 2018) ("While I do not know precisely the socially optimal number of loss absorbency requirements for large banking firms, I am reasonably certain that 24 is too many. Candidates for simplification include: elimination of the advanced approaches risk-based capital requirements ...."), *available at* https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm.

by adding another approach (i.e., SA-CCR) without fully replacing the existing approach (i.e., CEM). Third, the scope of application of the derivative exposure methodologies could be clarified to ensure counterparty credit risk capital charges are applied consistently.

Additional description of our primary comments on the Proposal is as follows:

• <u>The Proposal should be recalibrated for commercial end-user trades</u>: We provide derivative products and services to commercial end-users that enable these commercial entities to manage their interest rate, commodity, foreign exchange, and other risks that arise in conducting their core business activities. In turn, we manage the counterparty credit and market risk associated with providing these products and services to our customers. As we often provide loans, letter of credit facilities, and other financial products to these commercial end-users, we are able to mitigate the credit risk of these exposures without requiring daily margining of financial collateral. By accepting non-financial collateral and using other risk mitigation techniques, these counterparties are better able manage real commercial risks, while maintaining liquidity and reducing their hedging costs.

SA-CCR would apply burdensome capital requirements on trades with commercial end-users, relative to the other approaches. In contrast to CEM, SA-CCR would generally apply lower capital charges to trades with large dealer counterparties (i.e., those dealers subject to the Swap Margin Rule that have large numbers of off-setting derivatives transactions). Post-crisis initiatives generally have moved market participants toward greater levels of central clearing and margining. As a result, we appreciate the improvements in risk-sensitivity that SA-CCR provides for trades with large dealers. While SA-CCR was intended to further promote these objectives, the Proposal creates a significant disincentive for banks to enter into derivatives trades with commercial end-users that could be counter-productive in relation to other macroeconomic policy and financial stability objectives. To illustrate, we have provided details of the calculation of exposure amounts for a representative set of trades with commercial end-users in Appendix 1 of this comment letter. The examples show increases in exposure measures between SA-CCR and CEM ranging from 66-568%. The wide range of variances are due to the effects of combining significant increases imposed by SA-CCR in potential future exposure and more moderate increases imposed by SA-CCR to the replacement cost, which represents the amount owed by the counterparty to the bank as of the measurement date. Although we do not use the IMM, we would expect the exposure under IMM to be lower than CEM. As these examples demonstrate, SA-CCR assigns particularly high exposure amounts to trades with commercial end-users. If the proposed calibration of SA-CCR is unchanged, we expect the final rule would directly impact a commercial end-user's ability to hedge its business risks by increasing costs, promoting less effective hedging strategies, decreasing market liquidity, and ultimately may result in migration of the activity to the banking institutions not subject to SA-CCR or the non-supervised sector.

<u>The treatment of transactions with commercial end-users under SA-CCR is not consistent with the exemptions from the Swap Margin Rule and clearing mandate</u>: The Swap Margin Rule, which the Agencies finalized in October 2015,<sup>5</sup> requires swap entities to pay and receive initial margin and exchange variation margin for uncleared derivatives with financial end-users and other swap entities. Initial margin is only required for transactions between swap entities and financial end-users with material swap exposure. Similarly, initial and variation margin are required to collateralize cleared derivatives transactions. The Swap Margin Rule and mandatory clearing rules were careful to provide an exemption for certain trades with commercial end-users to avoid disrupting their ability to hedge exposures that arise during the normal

<sup>&</sup>lt;sup>5</sup> 12 C.F.R. Part 45 (OCC); 12 C.F.R. Part 237 (FRB); 12 C.F.R. Part 349 (FDIC).

course of business.<sup>6</sup> Congress mandated that the Agencies provide an additional exemption from the Swap Margin Rule when an entity is eligible for an exemption from mandatory clearing. In accordance with the definition of "Financial End-user," in the Swap Margin Rule, and the changes effected by TRIPRA, a swap entity's uncleared swaps with commercial end-users are not subject to initial and variation margin. These exemptions are based on sound policy considerations reflecting the fact that commercial end-users would face liquidity burdens and lack the operational infrastructure necessary to facilitate daily exchange of variation margin.

The exclusion of trades with commercial end-users in the Swap Margin Rule and mandatory clearing rules and the unfavorable treatment in SA-CCR for all trades not subject to margin requirements creates inconsistencies in the regulatory framework, thereby imposing significant increased costs on a bank's ability to provide necessary hedging services to commercial entities. Specifically, SA-CCR's adverse treatment of such trades overrides the benefit of the statutory and regulatory exemptions commercial end users received under the Swap Margin Rule and mandatory clearing rules. Given the high capital requirement under SA-CCR associated with derivatives trades that are not cleared through clearinghouses and not margined, banks that are subject to SA-CCR will have difficulty offering such trades to commercial end-users at competitive prices.

- The Agencies should consider modifications to the application of the SA-CCR methodology to commercial end-users: The relative over-calibration of SA-CCR and lack of alignment with the Swap Margin rule demonstrate that modifications to the Proposal are necessary to address its impact on commercial end-users. SA-CCR could be amended for trades with commercial end-users to recognize non-financial collateral subject to any necessary supervisory requirements and the bank having full recourse to the counterparty or non-financial collateral, including real and tangible property together with letters of credit. Furthermore, the maturity factor for such trades could follow the calculation for margined trades that are not cleared transactions and permit use of the 10 day ceiling. Additionally, given all of these commercial end-user trades would by definition only have right-way risk, the Agencies could collectively address the over-calibration of an alpha factor and applying a specific scalar to adjust the SA-CCR exposure at defaults ("EADs"). The Agencies could also consider a applying a further 65% adjustment to those counterparties that meet the Investment Grade ("IG") standard. We believe these solutions would allow end-user commercial customers to continue to hedge their commercial exposures and maintain consistency with the statutory and regulatory exemptions from swap margin requirements.
- <u>The Agencies should limit the number of applicable approaches for measuring derivative exposures to</u> <u>improve the efficiency and consistency of the regulatory framework</u>: The Proposal will result in up to three approaches to measuring derivative exposure for Advanced Approaches banks. We believe the number of methodologies for calculating exposure amounts for derivatives under the Proposal and in other contexts creates inefficiencies and unnecessary operational burden for banks and users of regulatory reports. The table below summarizes the available calculation options under the Proposal and other regulatory requirements:

<sup>&</sup>lt;sup>6</sup> Consistent with Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") as amended by the Terrorism Risk Insurance Program Reauthorization Act of 2015 ("TRIPRA"), the Swap Margin Rule exempted certain swaps with commercial end-users from requirements to exchange initial and variation margin on swaps that are not cleared through a clearinghouse.

Derivative Exposure Calculation Approach							
	Capital			Exposure Limits		Reporting+	Insurance Assessment
Bank Type	Standardized	Advanced	Supplementary Leverage	SCCL	OCC Lending Limit	FR Y-15	FDIC Assessment
Advanced	SA-CCR	SA-CCR/ IMM	SA-CCR	SA-CCR/ IMM	CEM/SA- CCR*	SA-CCR	CEM
Standardized	CEM/SA- CCR		CEM/SA-CCR	CEM/SA- CCR	CEM/SA- CCR*	CEM/SA- CCR	CEM
* SA-CCR added to permissible calculation methodologies (CEM, IMM and Conversion Factor Matrix Method)							
+ assuming reports change to reflect changes in this proposal							

To illustrate, an Advanced Approaches bank might use IMM for Advanced Approaches capital ratios and the Single-Counterparty Credit Limit rule; SA-CCR for Standardized Approach capital ratios, supplementary leverage, GSIB score calculation, and stress testing; and CEM for deposit insurance assessment calculation purposes (and possibly on certain reporting forms if report instructions are not changed to be consistent with any final SA-CCR rule).

Requiring calculation of multiple derivative exposure amounts and including optional approaches within the rules noted in the table above creates regulatory burden and increases the potential for competitive inequalities, particularly when the calibration of each approach varies widely. We believe the regulatory capital framework should include an appropriately calibrated, risk-sensitive standardized approach for calculating derivatives exposure that yields rationale results across banks of all sizes. As such, we encourage the Agencies ensure SA-CCR is calibrated appropriately for its broad use. If it's not possible to settle on one methodology for measuring derivative exposure, all approaches that are optional should be available in all situations. Finally, many regulatory reporting forms refer to the methodologies for calculating derivative exposure amounts. Some of these reports specifically refer to CEM. Any Final Rule should expressly provide that SA-CCR is appropriate for purposes of those reports and the respective reporting instructions should be updated accordingly.

- The scope of application should be clarified to ensure consistent treatment of arrangements that may give rise to counterparty credit risk: As noted below, there are instances where the scope of application of the exposure methodologies for derivatives transactions is unclear. We respectfully request that the Agencies clarify the scope of the Proposal in the following situations:
  - Derivatives that do not give rise to counterparty credit risk: The preamble to the Proposal states that the, "exposure amount would be zero, however, for a netting set that consists only of sold options in which the counterparties to the options have paid the premiums up front and the options are not subject to a variation margin agreement."<sup>7</sup> This exemption is expressly included in the proposed rule text for SA-CCR, but not for the other methodologies. Call Report instructions state "derivative"

<sup>&</sup>lt;sup>7</sup> 83 Fed. Reg. 64666 (Dec. 17, 2018).

contracts that are neither over-the-counter derivative contracts nor derivative contracts that are cleared transactions under §.2 of the regulatory capital rules [...] such derivative contracts include written option contracts" should be excluded from counterparty credit risk exposure measures. An FAQ Document from the BCBS<sup>8</sup> states that exposure can only be set to zero for, "sold options that are outside netting and margin agreements."

The final rule should clarify which of these viewpoints governs and apply the same scope of application to all regulatory measures of derivatives exposures (not just under SA-CCR). The regulatory capital rules should exempt sold options on which premiums have been paid from counterparty capital requirements in all cases. Sold options on which premiums have been paid should be excluded because they do not give rise to counterparty credit risk (i.e., the seller will never be in an asset position).

Transactions using a carry or third-party broker should be treated as cleared transactions: The application
of exposure calculation methodologies in certain instances depends on whether or not a particular
trade meets the definition of a "cleared transaction" under the capital rule. It is unclear whether a
transaction in which we clear a trade for a client on a qualifying central counterparty ("QCCP") through
a carry broker is a "cleared transaction."

In such situations, we find another entity that is a clearing member of the QCCP (a carry or third-party broker) to clear the trade. In such instances, our exposure is the same as when the third party broker is a member of the QCCP and clears the trade directly. Therefore, although the "exposure" to the carry broker/QCCP creates no economic exposure, the transaction may still be subject to the applicable exposure calculation methodology as though it were an OTC derivative. SA-CCR would significantly increase the exposure amounts and therefore capital associated with these transactions if they are not "cleared transactions." We believe the Proposal should clarify that such transactions involving a carry broker are cleared transactions and are treated accordingly (i.e., with exposure to carry broker/QCCP exempted) under all derivative exposure calculation methodologies.

• The definition of "current exposure" for certain derivatives transactions where we are acting as agent should be clarified: The methodologies for measuring derivative exposure rely in part on "current exposure,"<sup>9</sup> which SA-CCR defines as "the sum of the fair values (after excluding any valuation adjustments) of the derivative contracts" and the potential future exposure. In general, the GAAP classification of derivatives is consistent with the scope of transactions subject to derivatives exposure measurements under the capital rules. However, it is unclear how to treat the fair value of cleared transactions that are treated as OTC derivatives for risk-weighting purposes under the capital rule, as the fair values associated with such transactions are not derivative contracts under GAAP.

For such transactions, we record a receivable that is not tied to the derivative contract. The receivable reflects our role as agent in intermediating payment activities between the QCCP and our client – it does not arise from a derivative contract under GAAP. Receivables are typically risk-weighted as general credit exposures and are not subject to the derivatives exposure calculations unless they are classified as derivatives for GAAP. We request that the Agencies confirm these receivables are not derivative replacement costs for purposes of derivatives exposure calculations in the capital rules.

<sup>&</sup>lt;sup>8</sup> https://www.bis.org/bcbs/publ/d438.pdf

<sup>&</sup>lt;sup>9</sup> 12 C.F.R. § 217.2.

The Final Rule should clarify that commitments to enter into reverse repurchase agreements with CCPs are not default fund contributions: The Proposal includes a discussion of the treatment of default fund contributions to central counterparties (CCPs). Certain CCPs require members to provide funding in the form of a reverse repurchase agreement that can be initiated by the CCP in the event of a member default.<sup>10</sup> The reverse repurchase agreement would help ensure that the CCP can continue to provide clearing and settlement services to other clearing members following the default of the clearing member. The definition of "default fund contribution" in the Proposal could be interpreted expansively. Therefore, we seek confirmation that these reverse repurchase agreements are not unfunded "default fund contributions" under the Proposal.

### **Conclusion**

We respectfully request the Agencies revise the Proposal and align mandatory adoption of SA-CCR with the impending U.S. implementation of the Final Basel III package of reforms. Specifically, we recommend recalibrating the Proposal for trades with commercial end-users to harmonize the Proposal with Swap Margin Rule and mandatory clearing requirements. Additionally, we request that the Agencies reduce the number of methodologies for calculating derivatives exposure amounts. We also ask that the Agencies provide clarity within the rules regarding the scope of application for certain transactions subject to measurement under SA-CCR.

We appreciate the opportunity to comment on the Proposal and are available to provide additional input or clarifications as you proceed with further deliberations on this topic. If you have any questions, please feel free to contact me directly.

Sincerely,



Neal Blinde Executive Vice President and Treasurer

<sup>&</sup>lt;sup>10</sup> See, for example, the Fixed Income Clearing Corporation's Mortgage-Backed Securities Division's capped contingent liquidity facility.

## Appendix 1 – Examples of Trades not Subject to Margin Requirements

### Example 1: Muni Derivative Transactions:

Wells Fargo enters into derivatives with large, highly rated U.S. state and local governments and also with large, highly rated U.S. not-for-profit corporations. The latter are typically in the healthcare and higher education sectors. These customers primarily use swaps to hedge variable interest rate exposure associated with both publicly issued debt and private bank loans. The debt, loans and swaps are typically backed by either a pledge of ad valorem taxing power (in the case of the governmental entities) or a pledge of tax or other operating revenues. The debt, loans and swaps are generally not secured by real property. Margining terms for these arrangements vary. Some governmental entities are precluded by statute from posting collateral, while others may post collateral. Nevertheless, the market standard is to have a public ratings based collateral grid, where no posting is required until the customer's public rating falls to a certain level, e.g., A3/A-, at which point collateral is required subject to a threshold, e.g., only exposure above \$25 mm must be collateralized. These customers do not have to post or collect margin under the Swap Margin Rule.

The table below summarizes a transaction with a municipal governmental entity that is not allowed to post collateral. The trade has a replacement cost of \$46.4 million, and a remaining 25 year life. The notional add-on under SA-CCR results in 10.1% of notional held as exposure compared to 1.5% of notional under CEM. The 40% alpha addition to the replacement cost adds 18.56mm or 38% of total CEM EAD. The net result of both PFE add-on and replacement cost produces 66% higher EAD under SA-CCR vs. CEM. Accordingly, a 66% increase in EAD would result in a commensurate increase in risk weighted assets ("RWA") under the Standardized and Advanced Approaches. Under the Advanced Approach this same EAD would also be used to calculate Credit Valuation Adjustment RWA, which could result in total Advanced Approach RWA for this transaction exceeding the RWA requirements of holding a direct credit exposure (e.g., debt security) of the counterparty.

	СЕМ	SA-CCR	Percent Change
Notional	162,500,000	162,500,000	0
Effective PFE (alpha adjusted)	2,437,500	16,348,816	571%
PFE Percentage	1.5%	10.1%	571%
Replacement Cost (alpha adjusted)	46,421,879	64,990,630	40%
EAD	48,859,379	81,339,446	66%

#### Example 2: Interest-Rate Swaps with Commercial Customers:

Wells Fargo enters into interest rate swaps with commercial customers who have variable-interest rate real estate loans (e.g., manufacturer financing the development of a new production facility). These clients utilize pay-fixed interest rate swaps to hedge the interest rate risk of their loans. In most cases, the terms of the swap are paired with the loan. These customers collateralize the derivative with full recourse to real property instead of cash collateral in order to protect their liquidity position. These trades are statutorily exempt from the swap margin rule as noted in the section above.

The table below shows such an interest rate swap. A customer has a \$615 million, 5 year swap to a fixed interest rate with a replacement cost of \$1.8 million. The swap is the only transaction for this customer and hedges the customer's existing real estate loan with the bank. The PFE factor changes from 0.5% under CEM for an interest rate derivative with a 1-5 year maturity, to 2.2% under SA-CCR and is further adjusted upwards to 3.1% with an alpha of 1.4. Additionally under SA-CCR, the replacement cost of \$1.8 million is increased by 40% by the alpha

factor. As shown in the table, SA-CCR increases the EAD for this derivative by 340%, which would result in a corresponding 340% increase in RWA under both the Standardized and Advanced Approaches.

	СЕМ	SA-CCR	Percent Change
Notional	615,000,000	615,000,000	0
Effective PFE (alpha adjusted)	3,075,000	18,962,531	517%
PFE Percentage	0.5%	3.1%	517%
Replacement Cost (alpha adjusted)	1,809,378	2,533,129	40%
EAD	4,884,378	21,495,660	340%

#### Example 3: Commodity Producer or User Hedges:

Wells Fargo enters into derivatives with commodity producers and users, so that these customers can hedge their exposure to commodity price risk. Hedging allows these customers to stabilize cash flows, protects target returns on investments, reduces earnings volatility, reduces working capital requirements and enables these customers to achieve budget targets. Loan providers often require hedging to eliminate underlying commodity price risk. For producers, OTC hedging is preferable over exchange future hedging because OTC hedging can be collateralized through a lien on assets instead of cash collateral, which exposes the producer to liquidity risk.

The table below summarizes a group of option transactions with a natural gas producer with maturities ranging from 3 months to 4 years. The trades represent a net liability of \$21 million in the customer's favor. Given the presence of option structures, the SA-CCR notional is reduced to reflect the money-ness of the options, as opposed to the CEM notional which only considers the strike and quantity. Additionally, offsetting benefits are recognized under SA-CCR due to the presence of long and short positions within the netting set. Nevertheless, the SA-CCR PFE/Add-on factor for such trades is prohibitively high. As shown in the table, SA-CCR increases the EAD for this derivative by 568%. The resulting EAD change results in a corresponding 568% increase in RWA under both Standardized and Advanced Approaches.

	СЕМ	SA-CCR	Percent Change
Notional	715,302,675	570,649,929	-20%
Effective PFE (alpha adjusted)	33,517,355	223,837,717	568%
PFE Percentage	4.69%	39.23%	737%
Replacement Cost (alpha adjusted)	-21,283,154	-21,283,154	0%
EAD	33,517,355	223,837,717	568%