

DERIVATIVES FAIRNESS ACT

AUGUST 7, 2018.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. HENSARLING, from the Committee on Financial Services,
submitted the following

R E P O R T

together with

MINORITY VIEWS

[To accompany H.R. 5323]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 5323) to amend the Dodd-Frank Wall Street Reform and Consumer Protection Act to establish an exemption from the credit valuation adjustment calculation for uncleared derivatives transactions with end-users so that United States companies are not disadvantaged, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the “Derivatives Fairness Act”.

SEC. 2. CREDIT VALUATION ADJUSTMENT RELIEF.

(a) IN GENERAL.—The Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5361 et seq.), is amended by inserting after section 176 the following new section:

“SEC. 177. CREDIT VALUATION ADJUSTMENT.

“Prudential risk-based capital requirements and generally applicable risk-based capital requirements established by the appropriate Federal banking agencies shall not apply a fair value adjustment to reflect counterparty credit risk in valuation of over-the-counter derivative contracts with respect to transactions with a counterparty that—

“(1) is described under section 2(h)(7)(A) of the Commodity Exchange Act;

“(2) is a person or class of persons that meets any qualifications required by a regulation issued by the Commodity Futures Trading Commission with respect to such person or class of persons qualifying for an exemption under section 4(c)(1) of the Commodity Exchange Act from the requirements of section 2(h)(1)(A) of such Act; or

“(3) is an affiliate that meets the requirements for an exception under section 2(h)(7)(D) of the Commodity Exchange Act.”

(b) CONFORMING AMENDMENT.—The table of contents in section 1(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5301 note) is amended by inserting after the item relating to section 176 the following new item:

“Sec. 177. Credit valuation adjustment.”.

PURPOSE AND SUMMARY

On March 19, 2018, Representative Warren Davidson introduced H.R. 5323, the “Derivatives Fairness Act”. H.R. 5323 amends Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to add a new section 177 entitled “Credit Valuation Adjustment.” This new section would exempt non-cleared derivatives with certain counterparties commonly described as “end-users” from the costly Credit Valuation Adjustment (CVA) capital charge.

BACKGROUND AND NEED FOR LEGISLATION

The goal of H.R. 5323 is to eliminate unnecessary and burdensome costs for certain users of derivatives, commonly known as “end-users” to ensure that U.S. companies are not at a competitive disadvantage versus end-users operating in other global markets so they can better manage business risks, help sustain growth, create jobs, and provide goods and services to the economy with greater predictability in the price of those goods and services.

During the financial crisis, banks suffered significant counterparty credit risk (CCR) losses on their over-the-counter (OTC) derivatives contracts, which came mostly from fair value adjustments on derivatives, rather than counterparty defaults. But hedging activity by end-users did not contribute to the financial crisis; it also does not create meaningful systemic risk, as end-users comprise less than 10 percent of the notional amount of the OTC derivatives market.

Under the Basel II framework, CCR was designed to capitalize for default and migration risk rather than potential accounting losses. As a result, the Basel Committee on Banking Supervision introduced a new capital charge to address this regulatory gap in Basel III. The updated Credit Valuation Adjustment (CVA) capital charge was intended to improve banks’ resilience against potential mark-to-market losses relating to variability in counterparty credit risk for non-cleared derivatives trades. The CVA applies only to non-cleared trades, as exposures toward central counterparties are exempt from the CVA charge. Banks are permitted to reduce their CVA exposures through hedging by entering into credit default swaps (CDS).

In July 2013, the Board of Governors of the Federal Reserve System and other banking agencies approved final rules to enact the U.S. regulatory capital rules as part of a comprehensive framework that includes the adoption of the Basel III regime as well as capital provisions from the Dodd-Frank Act. Meanwhile, the European Union (EU) adopted their Basel III standards through the Capital

Requirements Regulation and Capital Requirements Directive, published in June 2013. In their regulations, however, the EU diverged from Basel III—and the U.S. implementation of Basel III—by adopting a CVA capital charge that exempts transactions between EU-based banks and non-financial corporations in order to reflect the exemption under the European Market Infrastructure Regulation (EMIR) to centrally clear derivative transactions for non-financial corporates. As a result, U.S. banks that have to apply a CVA charge for uncleared end-user derivatives contracts are at a competitive disadvantage vis-à-vis European banks. For instance, an end-user would likely find it cheaper to hedge interest rate risk with an EU dealer rather than a US dealer.

Additionally, the CVA charge for uncleared end-user derivatives transactions is inconsistent with end-user relief included in Title VII of the Dodd-Frank Act as well as amendments enacted in 2015. Title VII of the Dodd Frank Act provides exemptions from the clearing and margin requirements from certain qualifying derivatives transactions for end-users, but derivatives by end-users with U.S. banks still are subjected to the CVA capital charge. Again, at a competitive disadvantage as EU regulations align end-user relief with the CVA exemption.

End-users typically require fairly-priced, tailor-made and widely offered derivative products to protect core business activities from commercial and financial risk. End-users executing uncleared swaps with banking organizations that are subject to the CVA are likely to see increased transaction costs as the dealer bank is likely to pass along the CVA capital charge in the form of higher fees to execute these transactions. As part of testimony before the Subcommittee on Capital Markets, Securities, and Investment in February 2018, Scott O'Malia, CEO of the International Swap and Derivatives Association (ISDA), stated: “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.”

Further, Tom Deas, Chairman of the National Association of Corporate Treasurers testified before the Capital Markets Subcommittee in February 2018 on behalf of the Coalition for Derivatives End-Users that: “The lack of a CVA exemption in the United States significantly reduces the benefits of the statutory exemptions from clearing and margin requirements, which were granted by Congress under Dodd-Frank. An exemption would put U.S. businesses on equal footing with their non-U.S. counterparts.”

HEARINGS

The Committee on Financial Services held a hearing examining matters relating to H.R. 5323 on February 14, 2018.

COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on March 21, 2018, and ordered H.R. 5323 to be reported favorably to the House without amendment by a recorded vote of 34 yeas to 26 nays (recorded vote no. FC-174), a quorum being present.

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. A motion by Chairman Hensarling to report the bill favorably to the House without amendment was agreed to by a recorded vote of 34 yeas to 26 nays (Record vote no. FC-174), a quorum being present. An amendment offered by Representative Kihuen was not agreed to by a recorded vote of 25 yeas to 35 nays (FC-173), a quorum being present.

Record vote no. FC-173

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling		X		Ms. Maxine Waters (CA)	X		
Mr. McHenry		X		Mrs. Carolyn B. Maloney (NY) ..	X		
Mr. King		X		Ms. Velázquez	X		
Mr. Royce (CA)		X		Mr. Sherman	X		
Mr. Lucas		X		Mr. Meeks	X		
Mr. Pearce		X		Mr. Capuano	X		
Mr. Posey		X		Mr. Clay	X		
Mr. Luetkemeyer		X		Mr. Lynch	X		
Mr. Huizenga		X		Mr. David Scott (GA)	X		
Mr. Duffy		X		Mr. Al Green (TX)	X		
Mr. Stivers		X		Mr. Cleaver	X		
Mr. Hultgren		X		Ms. Moore	X		
Mr. Ross		X		Mr. Ellison	X		
Mr. Pittenger		X		Mr. Perlmutter	X		
Mrs. Wagner		X		Mr. Himes	X		
Mr. Barr		X		Mr. Foster	X		
Mr. Rothfus		X		Mr. Kildee	X		
Mr. Messer		X		Mr. Delaney	X		
Mr. Tipton		X		Ms. Sinema	X		
Mr. Williams		X		Mrs. Beatty	X		
Mr. Poliquin		X		Mr. Heck	X		
Mrs. Love		X		Mr. Vargas	X		
Mr. Hill		X		Mr. Gottheimer	X		
Mr. Emmer		X		Mr. Gonzalez (TX)		X	
Mr. Zeldin		X		Mr. Crist	X		
Mr. Trott		X		Mr. Kihuen	X		
Mr. Loudermilk		X					
Mr. Mooney (WV)		X					
Mr. MacArthur		X					
Mr. Davidson		X					
Mr. Budd		X					
Mr. Kustoff (TN)		X					
Ms. Tenney		X					
Mr. Hollingsworth		X					

Record vote no. FC-174

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling	X			Ms. Maxine Waters (CA)		X	
Mr. McHenry	X			Mrs. Carolyn B. Maloney (NY)		X	
Mr. King	X			Ms. Velázquez		X	
Mr. Royce (CA)	X			Mr. Sherman		X	
Mr. Lucas	X			Mr. Meeks		X	
Mr. Pearce	X			Mr. Capuano		X	
Mr. Posey	X			Mr. Clay		X	
Mr. Luetkemeyer	X			Mr. Lynch		X	
Mr. Huizenga	X			Mr. David Scott (GA)		X	
Mr. Duffy	X			Mr. Al Green (TX)		X	
Mr. Stivers	X			Mr. Cleaver		X	
Mr. Hultgren	X			Ms. Moore		X	
Mr. Ross	X			Mr. Ellison		X	
Mr. Pittenger	X			Mr. Perlmutter		X	
Mrs. Wagner	X			Mr. Himes		X	
Mr. Barr	X			Mr. Foster		X	
Mr. Rothfus	X			Mr. Kildee		X	
Mr. Messer	X			Mr. Delaney		X	
Mr. Tipton	X			Ms. Sinema		X	
Mr. Williams	X			Mrs. Beatty		X	
Mr. Poliquin	X			Mr. Heck		X	
Mrs. Love	X			Mr. Vargas		X	
Mr. Hill	X			Mr. Gottheimer		X	
Mr. Emmer	X			Mr. Gonzalez (TX)		X	
Mr. Zeldin	X			Mr. Crist		X	
Mr. Trott	X			Mr. Kihuen		X	
Mr. Loudermilk	X						
Mr. Mooney (WV)	X						
Mr. MacArthur	X						
Mr. Davidson	X						
Mr. Budd	X						
Mr. Kustoff (TN)	X						
Ms. Tenney	X						
Mr. Hollingsworth	X						

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the Committee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 5323 will reduce transaction costs and provide regulatory fairness by eliminating the CVA charge for uncleared end-user derivatives contracts.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

CONGRESSIONAL BUDGET OFFICE ESTIMATES

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 1, 2018.

Hon. JEB HENSARLING,
Chairman, Committee on Financial Services,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 5323, the Derivatives Fairness Act.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Kathleen Gramp.

Sincerely,

KEITH HALL,
Director.

Enclosure.

H.R. 5323—Derivatives Fairness Act

Summary: H.R. 5323 would prohibit the federal financial regulators from requiring banks to hold capital against certain derivative contracts. Under current law, the calculation of a bank's capital requirement includes amounts for some derivative contracts.

CBO estimates that implementing H.R. 5323 would, on net, increase the deficit by \$2 million over the 2019–2028 period. That estimate includes an increase in direct spending of \$2 million and an

increase in revenues of less than \$500,000. Because enacting the bill would increase direct spending and revenues, pay-as-you-go procedures apply.

CBO estimates that enacting H.R. 5323 would not increase net direct spending by more than \$2.5 billion or on-budget deficits by more than \$5 billion in any of the four consecutive 10-year periods beginning in 2029.

H.R. 5323 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA).

Basis of estimate: For this estimate, CBO assumes that the bill will be enacted near the end of 2018. The budgetary effects of H.R. 5323 stem from the small chance that the Federal Deposit Insurance Corporation (FDIC) would incur additional costs to resolve financial institutions that fail.

This cost estimate is based on the analysis underlying projections for the FDIC's financial resolution programs included in CBO's April 2018 baseline. Those projections incorporate a weighted probability of different outcomes for future failures of financial institutions. Most of those outcomes have a very small probability of occurring, but if they did, the costs to the FDIC's Deposit Insurance Fund (DIF) or the Orderly Liquidation Fund (OLF) would be very large.¹ On balance, CBO estimates that the federal regulations that require banks to maintain certain levels of capital and liquidity lower the FDIC's costs for resolving failed financial institutions because they increase the proportion of losses that will be absorbed by shareholders and other creditors.

Under H.R. 5323, banks would no longer be required to account for some derivatives in their calculation of capital ratios that are based on what are known as a bank's risk-weighted assets (RWA). Only institutions bound by the RWA ratio would be affected by the bill.

On the basis of publicly available information about the amount of capital held by banks for affected derivatives, CBO estimates that implementing H.R. 5323 would, on net, increase deficits by \$2 million over the 2019–2028 period. That estimate includes an increase in direct spending of \$2 million and an increase in revenues of less than \$500,000 for the OLF. Those budgetary effects are small relative to the \$14.2 billion net cost that CBO projects for the OLF over that 10-year period. CBO estimates that most of the cost of H.R. 5323 would be offset after 2028 by an increase in fees paid by financial institutions. Finally, CBO estimates that implementing the bill would have no significant net effect on the DIF.

Pay-as-you-go considerations: The Statutory Pay-As-You-Go Act of 2010 establishes budget-reporting and enforcement procedures for legislation affecting direct spending or revenues. Because H.R. 5323 would affect direct spending and revenues (as discussed above) pay-as-you-go procedures apply.

Increase in long-term direct spending and deficits: CBO estimates that enacting H.R. 5323 would not increase net direct spending by more than \$2.5 billion or on-budget deficits by more than

¹The DIF, which is funded by premiums paid by member institutions, resolves the assets of failed insured depository institutions and insures certain deposits up to \$250,000 per depositor. The OLF was established to resolve failures of certain large, systemically important institutions—banks and nonbanks. In the event of a failure, the OLF's costs would largely be recouped by assessments (which would be recorded as revenues in the federal budget) collected from other large financial institutions.

\$5 billion in any of the four consecutive 10-year periods beginning in 2029.

Mandates: H.R. 5323 contains no intergovernmental or private-sector mandates as defined in UMRA.

Estimate prepared by: Federal Costs: Kathleen Gramp (Orderly Liquidation Fund) and Sarah Puro (Deposit Insurance Fund); Mandates: Jon Sperl.

Estimate reviewed by: Kim P. Cawley; Chief, Natural and Physical Resources Cost Estimates Unit; H. Samuel Papenfuss; Deputy Assistant Director for Budget Analysis.

FEDERAL MANDATES STATEMENT

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995.

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

EARMARK IDENTIFICATION

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

DUPLICATION OF FEDERAL PROGRAMS

In compliance with clause 3(c)(5) of rule XIII of the Rules of the House of Representatives, the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program; (2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111-139; or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Pub. L. No. 95-220, as amended by Pub. L. No. 98-169).

DISCLOSURE OF DIRECTED RULEMAKING

Pursuant to section 3(i) of H. Res. 5, (115th Congress), the following statement is made concerning directed rule makings: The Committee estimates that the bill requires no directed rule makings within the meaning of such section.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Short title

This section cites H.R. 5323 as the “Derivatives Fairness Act”.

Section 2. Credit valuation adjustment relief

This section amends the Dodd-Frank Wall Street Reform and Protection Act to ensure that regulations issued by the federal banking agencies to promulgate minimum risk-based capital requirements do not apply a fair value adjustment to reflect counterparty credit risk in valuation of OTC derivatives contracts for qualifying transactions with corporate end-users.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, and existing law in which no change is proposed is shown in roman):

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italic and existing law in which no change is proposed is shown in roman):

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT**SECTION 1. SHORT TITLE; TABLE OF CONTENTS.**

(a) **SHORT TITLE.**—This Act may be cited as the “Dodd-Frank Wall Street Reform and Consumer Protection Act”.

(b) **TABLE OF CONTENTS.**—The table of contents for this Act is as follows:

Sec. 1. Short title; table of contents.

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TITLE I—FINANCIAL STABILITY

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Subtitle C—Additional Board of Governors Authority for Certain Nonbank Financial Companies and Bank Holding Companies

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Sec. 177. Credit valuation adjustment.

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TITLE I—FINANCIAL STABILITY

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Subtitle C—Additional Board of Governors Authority for Certain Nonbank Financial Companies and Bank Holding Companies

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SEC. 177. CREDIT VALUATION ADJUSTMENT.

Prudential risk-based capital requirements and generally applicable risk-based capital requirements established by the appropriate Federal banking agencies shall not apply a fair value adjustment to reflect counterparty credit risk in valuation of over-the-counter derivative contracts with respect to transactions with a counterparty that—

(1) is described under section 2(h)(7)(A) of the Commodity Exchange Act;

(2) is a person or class of persons that meets any qualifications required by a regulation issued by the Commodity Futures Trading Commission with respect to such person or class of persons qualifying for an exemption under section 4(c)(1) of the Commodity Exchange Act from the requirements of section 2(h)(1)(A) of such Act; or

(3) is an affiliate that meets the requirements for an exception under section 2(h)(7)(D) of the Commodity Exchange Act.

* * * * *

MINORITY VIEWS

H.R. 5323 would allow megabanks to ignore risks from certain derivatives transactions when calculating their capital buffers that are supposed to prevent the bank's failure during adverse economic conditions. Specifically, the bill would exempt derivatives transactions with end-users that are not conducted through a clearing house from the credit valuation adjustment (CVA) to a bank's capital requirement.

The CVA represents the change to the value of a derivative contract to account for the likelihood that the customer of the bank or counterparty might default on its obligations under the contract. Banks are required to account for these derivatives on a fair value basis, meaning that they have to periodically update the value of the derivative based on changes in their counterparty's default risk, among other factors. The Basel Committee on Banking Supervision (BCBS) found that during the 2008 financial crisis roughly two-thirds of counterparty credit risk losses during the financial crisis resulted from bank writedowns of fair value in connection with CVA, while only one-third of such losses resulted from actual defaults.

Consistent with the Basel III accords, U.S. banking regulators required that the largest banks, those with more than \$250 billion in assets, hold capital to account for CVA to ensure they are better prepared if the party on the opposite side of a derivative transaction experiences a deterioration in creditworthiness or defaults on its obligation.

H.R. 5323 would amend this requirement based entirely on the determination by the European Union to exclude CVA from the calculation of European banks' capital requirements under Basel III. Notably, European governments tend to provide significantly more support to prop up their banking sectors, as well as other industries, a practice that Democrats sought to end in the United States through the enactment of the Dodd-Frank Act.

Supporters of H.R. 5323 claim that relief is necessary because the differences in treatment of CVA between the United States and European Union have put U.S. derivatives end-users, like airlines and gas companies, at a competitive disadvantage relative to their European counterparts. U.S. regulators, however, determined that the risks that these counterparties pose to banks should be accounted for to promote the safety and soundness of the banking industry and to promote the public good.

Importantly, H.R. 5323's supporters have offered no evidence of a competitive disadvantage. In fact, during a February 14, 2018 Capital Markets Subcommittee hearing on H.R. 5323 and other proposals, a representative of the International Swaps and Derivatives Association testified that, "we are trying to assess what the new Basel requirements would do to impact U.S. traders. And it is

very important we do the economic analysis,” (emphasis added). During the Committee’s consideration of the bill, Rep. Kihuen offered a sensible amendment to ensure that Congress first receives such an economic analysis. Consistent with a bill from the 113th Congress that received unanimous approval in Committee and passed the House Floor by a vote of 353–24, Rep. Kihuen’s amendment would have replaced H.R. 5323’s carve out with a requirement that the Financial Stability Oversight Council (FSOC) conduct a study of the potential effects of the differences between the United States’ and other jurisdictions’ implementation of the CVA capital requirement under Basel III. Rep. Kihuen’s amendment was rejected on party lines.

H.R. 5323 is opposed by proponents of responsible banking practices, like Public Citizen and Americans for Financial Reform (AFR). In a letter to the Committee, AFR cautioned that, “we should not use the European banking system—which is generally recognized as significantly undercapitalized compared to the U.S. system as the standard for our banking and derivatives regulations. In the long run, U.S. banks will be more competitive when they are generally recognized as safe and sound.”

For these reasons we oppose H.R. 5323.

MAXINE WATERS.
CAROLYN B. MALONEY.
STEPHEN F. LYNCH.
GREGORY W. MEEKS.
ED PERLMUTTER.
DAVID SCOTT.
NYDIA M. VELÁZQUEZ.
KEITH ELLISON.
WM. LACY CLAY.
MICHAEL E. CAPUANO.
JOYCE BEATTY.
AL GREEN.