January 16, 2024

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Mr. James P. Sheesley
Assistant Executive Secretary
Attention: Comments/Legal OES (RIN 3064-AF29)
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, D.C. 20429
Chief Counsel's Office
Attention: Comment Processing

Mr. Benjamin W. McDonough
Senior Deputy Comptroller
and Chief Counsel
Office of the Comptroller of the Currency
400 7th Street S.W.
Suite 3E-218
Washington, D.C. 20219

Re: Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity (the "Proposal")
Federal Reserve: Docket No. R-1813, RIN 7100-AG64
FDIC: RIN 3064-AF29
OCC: Docket ID OCC-2023-0008

Dear Ms. Misback, Mr. Sheesley, Mr. McDonough and Agency Colleagues:

As the author of *The Post-Reform Guide to Derivatives and Futures* (John Wiley & Sons, Inc. 2012)(the "Guide") and as an attorney entering my 29th year of private practice, I greatly respect and appreciate your efforts to consider comments to understand the impact of the Proposal.

On July 27, 2023, the Board of the Federal Deposit Insurance Corporation ("FDIC") approved a Notice of Proposed Rulemaking ("NPR") which would revise and strengthen the capital requirements applicable to the largest banking organizations. Subsequently, the Board of Governors of the Federal Reserve System (the "Board"), the FDIC and the Office of the Comptroller of the Currency (the "OCC" and collectively with the Board and FDIC, the "Agencies") published on September 18, 2023 the Proposal to substantially revise capital requirements appliable to certain large banking organizations. The Agencies subsequently extended the deadline for comments with respect to the Proposal to January 16, 2024. I am grateful for both the extension of the comment period and for your consideration of these comments.

Executive Summary

Financial regulatory reform measures in the area of capital should promote stability in the banking sector without burdening the market generally and, in particular, real estate market participants and others that need interest rate derivatives in order to manage risk.

Real estate borrowers in an era of high interest rates are increasingly burdened by the cost of interest rate caps and swaps –plain vanilla derivatives which played no role in developments leading to the Great Recession of 2008.[1]

The real estate industry faces significant debt maturities and refinancing needs in the foreseeable future. In November 2023, the leading data service firm Trepp estimated based on Fed Flow of Funds data that $351 billion in multifamily bank loans will mature before 2027. Trepp also calculated last year that nearly $450 billion in commercial real estate loans will soon mature. To the extent that much of this real estate debt will likely be refinanced in an economy in which interest rates continue to be high, the need for financial instruments, such as interest rate swaps and caps, will be great today and in the foreseeable future.

I am personally concerned that in this environment, many financial instruments which are critically important for managing interest rate risk will become more expensive if the Agencies require enhanced capital requirements, based in part on derivatives use, in connection with the implementation of Basel III (the "Basel III Endgame"). The Basel III Endgame should not treat all derivatives as equally complex and destructive and as "public enemy number one."[2]

Whether or not policymakers consider ubiquitous interest rate derivatives as complex or not, the Proposal may have as an unintended consequence the ***de***stabilization of the real estate market (and other key markets) due to large numbers of real estate and other market participants being priced-out of traditional interest rate risk management measures which become too expensive due to capital requirements in the Basel III Endgame.

To the extent that the Proposal *discourages* risk management by interest rate derivatives due to cost, I recommend in this letter making specific adjustments to the Proposal.

These adjustments would enable the Agencies to not only continue to strengthen the financial system, but also enable market participants to continue to manage risk at a cost that is not raised as byproduct of enhanced capital requirements.

Members of Congress have long shared the concern that I voice today: imposing capital and collateral requirements on banks (such as, in this case, U.S. global, systemically important bank holding companies ("GSIB's") and their affiliates or other large trading desks offering OTC derivatives) will drive-up the cost of risk management with respect to, for example, a real estate

---

[1] *See generally*, the Guide at 1-82.

[2] "Following the 2008 market crises, derivatives were the subject of historic reform. Although certain aspects of that reform were necessary, others appear to be based on a firmly-held belief by a few influential policymakers that derivatives were public enemy number one." The Guide at xiii.

borrower's obligation (typically imposed by its lender) to execute an interest rate swap or cap as a condition to obtaining loan proceeds.

In the Guide which I wrote and after extensive personal research and more formal practice over the years, I conclude that regulators generally have treated all OTC derivatives —as a whole— as having the same profile of complexity and presenting the same degree of risk despite their utility and permanence in our economy.[3]

Members of Congress over the years have made clear that policymaking should not create disincentives for corporates to manage risk. To illustrate, over a decade ago and as prudential and other regulators were finalizing rules to bring to legal life the systemic financial risk measures called for by Title VIII of the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), members of Congress expressed the same concern that I articulate in this letter.

For example, Senator Tim Johnson (D-SD), Senator Debbie Stabenow (D-MI), Representative Spencer Bachus (R-AL) and Representative Frank Lucas (R-OK) wrote in their April 6, 2011 letter to Chairmen Gary Gensler (Chairman of the U.S. Commodity Futures Trading Commission ("CFTC")), Mary Schapiro (SEC Chair), Board Chairman Ben Bernanke and Secretary Timothy Geithner of the U.S. Department of the Treasury wrote, "While we have been encouraged by many of your comments regarding capital and margin requirements, we write to reiterate the critical importance of establishing a regulatory regime that will not create economic disincentives for end-users to access the derivatives markets."[4]

House Committee on Agriculture Chairman Lucas and Senate Committee on Agriculture, Nutrition and Forestry Chair Debbie Stabenow wrote in a June 20, 2011 letter: "In crafting Title VIII of Dodd-Frank, [members of] Congress ... urged regulators '...to ensure that any new capital requirements are carefully linked to the risk associated with the uncleared transactions and not used as a means to deter over-the-counter derivatives trading."[5]

Senate Committee on Agriculture, Nutrition and Forestry Chairman Stabenow and Ranking Member Roberts stated in a February 22, 2011 letter to Chairman Gensler: "We appreciate your sensitivity to the concerns of commercial and agricultural end-users, who use derivatives to manage risks associated with their operations. As these people and businesses really had nothing to do with the financial crisis, we urge you to continue conversations with these market participants and to take their concerns into consideration as you write final rules so that their costs of risk management allow them to remain competitive."[6]

---

[3]"Derivatives should not be intimidating, but they are to many; yet they are all around us, an indelible part of our everyday decision making and economies at all levels. They are impossible to remove and therefore will remain in our everyday life until the end of time, just as they existed in the beginning of time, as we shall see in the history of derivatives provided in Chapter 8." The Guide at xiv.

[4]Coalition for Derivatives End-Users Letter at pp. 6-7, n.13, submitted in connection with the Advanced Approaches Risk-based Capital Rule and Market Risk Capital Rule (OCC Docket Number OCC-2012-0010 (RIN 1557-AD46) Board Docket No. R-1442 (RIN 7100AD-87); FDIC RIN3064-AD97).

[5]*Id.*

[6]*Id.*

OTC Interest Rate Derivatives Should Be Excluded as a Basis for Calculating Capital Requirements

The Agencies currently have proposed that GSIB's count all notional values of OTC derivatives to reflect complexity and risk which the Agencies presume are inherent in all OTC derivatives,[7] which includes a requirement that GSIB's calculate the notional values of all OTC derivatives, in the aggregate, and use that value as a "surcharge input." The Proposal uses the aggregate notional value to determine "Complexity" (of the holdings and business of GSIB's)). The Proposal states that "OTC derivatives contribute to complexity" but the Proposal asks "whether the banking organization is a primary or secondary obligor or whether there is a more accurate representation of the notional amount of OTC derivatives exposures that would improve the Board's ability to assess systemic risk."

However, for several compelling reasons detailed on the pages that follow, using the aggregate notional value of all GSIBs' derivatives is a rather blunt and imprecise way to assess the complexity of banks or systemic risk.

My comment and recommendation begins with a brief discussion of interest rate derivatives executed and settled OTC and, as a starting point, a common meaning of "notional value," a term which is used not only in the real estate risk management industry but in other industries as well.

Notional Value

GSIB's do not by themselves *create* notional value out of thin air. The notional value of an OTC derivative is the "amount" or the "size" of a derivative and that value typically corresponds to a loan or other transaction giving rise to a given risk (such as, in the real estate industry, the risk that interest rates will move upward in such a way as to outstretch a commercial real estate borrower's ability to repay both loan principal and interest calculated on an index).

To continue in the real estate context, if a GSIB or other regulated bank makes a loan to a borrower with interest (not fixed, but based on an index or benchmark) in the amount of $25,000,000, that lender typically requires the borrower to execute either a swap (to convert floating interest rate repayment risk to a fixed payment) or a cap (which provides the borrower with, in essence, an insurance policy for the borrower whereby another party, a cap provider, pays interest above a certain level, in exchange for the borrower's payment of a fee, or a premium). The notional value of either the swap or the cap purchased by the borrower generally matches the principal amount of the loan, in this example: $25,000,000. Payments in connection with the derivative are then calculated typically by the dealer in its role as Calculation Agent and these payments are based on the size of the derivative, in this case, $25,000,000 and the payments are either made only at execution (in the case of a cap) or throughout the term of the derivative which will mature when the underlying loan matures.

[7] *See* the Proposal, Table 1 (Measurement of GSIB Surcharge Inputs for GSIB's).

Complexity

Interest rate swaps and caps are OTC derivatives which are so ubiquitous, so common and are generally so straightforward as to commonly be referred to in derivatives trade parlance as "plain vanilla" derivatives. There generally are no complex terms in many interest rate derivatives. In all or nearly all cases, there is no heightened risk feature such as leverage, which played a critically adverse role by speculators using derivatives in the run-up to the Great Recession of 2008.[8]

The purchasers of interest rate swaps and caps are not speculators but execute these financial instruments typically to fulfill a requirement by their lenders. In nearly every case, these plain vanilla derivatives bear a striking resemblance to insurance; state insurance commissioners sought to regulate them before Title VII of Dodd-Frank relegated interest rate derivatives to the regulatory ambit and jurisdiction of the CFTC.[9] Generally, interest rate swaps and caps (in the real estate or other industry) fully-performed and jeopardized no market in 2008 or at any other point in our financial history.

The Proposal would require GSIB's to calculate not only the notional values of all real estate swaps and caps executed by borrowers, but the notional values of the derivatives of all *other* categories of derivatives, including the most exotic, leveraged, and complex ("bespoke" or customized) derivatives of GSIB's or other financial or banking institutions with large trading books. In this way, the Proposal lumps together the plain vanilla OTC derivatives together with leveraged credit default swaps and other highly complex derivatives (which in a largely unregulated pre-September 2008 market were exploited for gain --putting the entire financial system at great risk-- by market participants driven primarily by speculation).

Under the Proposal, a GSIB making, for example, only real estate interest rate swaps and caps would facilitate risk management in our industry but would be treated no differently than a GSIB generating the same notional amount --but with a stable of large hedge fund clients executing only highly-leveraged, exceedingly complex, speculative credit default swaps (which are far riskier and more complex OTC derivatives than interest rate caps or swaps executed by real estate borrowers, and which jeopardized our financial system in late 2008), for example.

With this illustration, the Proposal's use of the aggregate notional value as an input (without any differentiation with respect to the type of derivatives generating the notional value) to determine "Complexity" is a blunt and imprecise measurement of complexity and an inaccurate means to assess systemic risk from OTC derivatives.

Capital requirements based on notional value inputs may result in capital requirements imposed in such a way as to make ubiquitous OTC derivatives such as real estate interest rate caps and swaps being more costly to the very market participants who must execute them as a condition to real estate (and other) loans.

---

[8] *See* the Guide at pp. 59-60; 87-92 (detailing the misuse of derivatives, excessive leverage and failures of Long-Term Capital Management, Lehman Brothers and others).

[9] The Guide at pp. 139-40.

Question 12 within the Proposal asks "What are the advantages and disadvantages of including in the interconnectedness and complexity indicators guarantees of client performance to a CCP (i.e., a clearinghouse for derivatives or Central Clearing Party) with respect to client cleared derivative positions?" I provide two responses to this question: first, derivatives settled by highly regulated CCP's have historically posed no material systemic risk and therefore today should not be considered as inputs in margin calculations called for by the Proposal. Complexity indicators are important but for the reasons stated in this letter, the aggregate notional value of a trading book is not an indicator of complexity *per se*. There are more precise ways to evaluate both complexity and risk presented to our financial system.

I recommend that a more precise way to assess complexity and risk is to require GSIB's and other banks and financial services firms to differentiate between the notional values: (i) of less-complex, plain vanilla derivatives without leverage features or other complexity (real estate interest rate swaps and caps are among the most plain vanilla derivatives in the OTC market); and (ii) of each category of derivatives (*e.g.*, interest rate, equity, credit, currency and commodity) with an eye toward a separate risk measurement for the degree of complexity of the derivative and the role, or extent that the category of derivatives actually played in past market crises.

Alternatively, I urge the Agencies to alter the Proposal such that GSIB's do not count interest rate swaps and centrally-cleared derivatives in the notional derivatives component part of capital calculations. Capital requirements should not be imposed on GSIB's and large trading desks within the regulatory jurisdiction of the Agencies when the parties they face on derivatives are executing the financial instruments to manage risk (as opposed to entering into OTC derivatives for the kinds of speculative purposes with the kind of leverage which in fact led to the destabilization of markets in 2008).

Conclusion

I share the Agencies' longstanding desire and commitment to address the need to maintain both a robust financial system and vibrant markets in our economy. As we enter 2024, it is clear that real estate borrowers and many others in the market continue to be challenged in an era of high interest rates with maturing loans and the need to manage the risk of high interest rates.

I am deeply concerned that in this environment, many financial instruments which are critically important for managing interest rate risk will become more expensive if the Agencies require enhanced capital requirements as a part of the Basel III Endgame. Requiring GSIB's to calculate and use as inputs the notional value of all derivatives (even derivatives without complexity and derivatives which historically have presented minimal or no risk to the financial system as a whole) is an imprecise method for measuring complexity and for assessing risk, and may result in the destabilization of the real estate market if real estate market and other market participants are priced-out of traditional interest rate risk management measures which become too expensive due to capital requirements in the Basel III Endgame.

***

Once again I thank you for your consideration of these comments. I am available at (213) 200-1901 in the event that there are questions concerning this submission.

Thank you.

Very truly yours,
/S/
Gordon F. Peery, Esq.