FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

THOMAS M. HOENIG
VICE CHAIRMAN

July 16, 2015

The Honorable Harold Rogers
Chairman
Committee on Appropriations
United States House of Representatives
Washington, D.C. 20515

The Honorable Nita M. Lowey
Ranking Member
Committee on Appropriations
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Rogers and Congresswoman Lowey,

The Appropriations Committee recently adopted an amendment encouraging the CFTC not to impose inter-affiliate margin requirements on uncleared swaps. The proponents of the amendment state that requiring such margin will discourage prudent risk management, increase costs, and reduce liquidity. They further states that such internal swaps benefit customers. I am writing to respond to this amendment, in my capacity as Vice Chairman of the Federal Deposit Insurance Corporation.

The purpose of margin requirements is to keep the banking industry and the markets they serve competitive and stable throughout the economic cycle. Inter-affiliate margin ensures there is sufficient capital and liquidity to the financial firm and the market, should any unit of a consolidated banking company find itself in a position where it cannot serve end-users, or where its failure becomes a threat to the broader economy and the taxpayer.

Given the valuable subsidies provided to US banks, including the implicit presumption that such banks will be bailed out, large banking organizations have every incentive to put as much of the risk they take as possible into the US bank. To accomplish this, affiliates often enter into uncleared swaps transactions with the bank. Without margin exchanged for these trades, US banks effectively take on the risks of their affiliates. Further, these affiliates can often operate with less capital and liquidity reserves than the market would otherwise require, as market participants treat these affiliates as if they were an extension of the bank.

Affiliates of the largest banks are not limited to other banks and broker-dealers. Instead, these entities can include insurance companies, asset managers, overseas operations for trading derivatives, commodity companies, and other commercial entities. For example, requiring JP Morgan's affiliate operating in London to post margin to JP Morgan's US Bank, would have helped keep the London Whale trading losses outside of the federally-insured bank.

The exchange of margin between affiliates does not put banks or their customers at a disadvantage. Instead, requiring this margin will minimize the amount of risk that can be brought into the taxpayer-funded safety net, reduce excess leverage at the largest banks, ensure that liquidity will continue to be available to farmers and ranchers in periods of economic stress, and make it easier to resolve large financial firms. As we've recently seen, in periods of economic distress, firms that are excessively leveraged are not able to provide liquidity and credit to the market.

While it is true that some jurisdictions do not require the exchange of inter-affiliate margin, requiring US financial companies to exchange inter-affiliate margin will make the system and the largest banks more stable and more competitive throughout the economic cycle. It's never a competitive disadvantage to operate in a more stable and robust financial system, as the banks that entered the financial crisis with the lowest capital levels quickly discovered.

If we choose not to require inter-affiliate margin, we in effect are further extending another subsidy to the largest banking companies, another risk to the broader financial system, and ultimately another cost to the taxpayer.

I strongly support the efforts to ensure that inter-affiliate margin is appropriately exchanged, and I welcome further discussion so that we can come to an informed decision on the issue.

Sincerely,

Thomas M. Hoenig

cc: Members of the United States House of Representatives Committee on Appropriations
United States Senate Committee on Appropriations
United States Senate Committee on Banking, Housing and Urban Affairs
United States Senate Committee on Agriculture, Nutrition and Forestry
United States House of Representatives Committee on Financial Services
United States House of Representatives Committee on Agriculture