Center for American Progress

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

**Office of the Comptroller of the Currency**
**Chief Counsel's Office, Attention: Comment Processing**
**400 7th Street SW, Suite 3E-218**
**Washington, DC 20219**

**Federal Deposit Insurance Corporation**
**Robert E. Feldman, Secretary, Attention: Comments/Legal ESS**
**550 17th Street, N.W.**
**Washington, D.C. 20429**

**Federal Housing Finance Agency**
**Alfred M. Pollard, General Counsel, Attention: Comments**
**Constitution Center (OGC Eighth Floor), 400 7th St. SW**
**Washington, DC 20219**

**Farm Credit Administration**
**Barry F. Mardock, Deputy Director, Office of Regulatory Policy**
**1501 Farm Credit Drive**
**McLean, VA 22102-5090**

RE: Margin and Capital Requirements for Covered Swap Entities

Ladies and Gentlemen:

The Center for American Progress ("CAP") welcomes the opportunity to comment on the proposed rulemaking on margin and capital requirements for Covered Swap Entities ("CSEs") issued by the Board of Governors of the Federal Reserve System ("Fed"), Office of the Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corporation ("FDIC"), Federal Housing Finance Agency ("FHFA"), and Farm Credit Administration (collectively, "the Agencies").[1] CAP is an independent nonpartisan policy institute that is dedicated to improving

[1] CAP would like to thank the Agencies for their decision to re-open and extend the public comment period for this rulemaking.

the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action.

## I. Introduction

CAP strongly opposes eliminating the requirement for insured depository institutions ("IDIs") to collect initial margin for swaps transactions with affiliates. This change would reduce the loss-absorbing resources available to protect the IDI by roughly $40 billion, increasing risks to taxpayers and broader financial stability.[2] The Agencies' stated justifications for this element of the proposal lack merit, and in some cases, are directly contradicted by the data.

The buildup of excessive risk in the highly complex, interconnected, and unregulated segment of the derivatives market (referred to as the "swaps" market), was a critical vulnerability in the financial system in the lead up to the 2007-2008 financial crisis.[3] Losses from swaps exposures contributed to the failure or near failure of a multitude of systemically important financial institutions, some of which were then bailed out by the U.S. taxpayer.[4] The magnitude and interconnected nature of such exposures meant that stress in this market cascaded throughout the financial system and amplified both the severity of the financial crisis and the resulting catastrophic spillover effects on the real economy.

## II. Inter-affiliate initial margin is a critical safeguard

Following the crisis, one of policymakers' primary goals was to subject swaps transactions to a robust regulatory framework. Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") brought the swaps market out of the shadows and mandated a series of requirements designed to enhance transparency and financial stability.[5] One such requirement was the posting of initial and variation margin for swaps transactions that are not cleared through central counterparties. Posting margin ensures that collateral is available to mitigate potential losses to an entity if a counterparty defaults on its obligations, and more broadly, limits the buildup of leverage in swaps transactions across the financial system.

In 2015, the Agencies finalized the margin rules mandated by Dodd-Frank.[6] Among other requirements, the 2015 final rule required IDIs to collect initial margin from, but not post initial

[2] Martin J. Gruenberg, "Statement by Martin J. Gruenberg, Member, FDIC Board of Directors on the Notice of Proposed Rulemaking: Swap Margin Requirements," September 17, 2019, available at https://www.fdic.gov/news/news/speeches/spsep1719.html.
[3] Gary Gensler, "Testimony of Gary Gensler, Chairman, Commodity Futures Trading Commission before the U.S. Senate Banking, Housing and Urban Affairs Committee," February 14, 2013, available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-131.
[4] Id.
[5] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Title VII, Public Law 203, 111th Cong., 2nd sess. (July 21, 2010), available at https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.
[6] Margin and Capital Requirements for Covered Swaps Entities, Final Rule, Federal Register, Volume 80, No. 229, November 30, 2015, 74840-74912, available at https://www.govinfo.gov/content/pkg/FR-2015-11-30/pdf/2015-28671.pdf.

margin to, affiliates when engaging in non-cleared swaps transactions. A large share of the deposit liabilities issued by IDIs are explicitly backed by the U.S. taxpayer. Requiring IDIs to collect initial margin from affiliates limits the chances the IDI takes on losses and fails if the affiliate is unable to meet its obligations under the swaps transaction. Oftentimes, the affiliates are located in foreign jurisdictions that may not have a robust derivatives regulatory and supervisory framework in place.[7] Risks abroad can swiftly land on U.S. shores through this type of derivatives transaction, making safeguards like initial margin requirements critical. Overall, this important protection for IDIs limits leverage, promotes financial stability, and reduces the likelihood that taxpayers and the broader economy are asked to foot the bill for un-checked risk taking in the banking system.

**III. The Agencies' stated justifications for eliminating this safeguard fall short**

The proposed rulemaking issued by the Agencies would remove this sensible protection. This change would release about $40 billion of collateral presently available to IDIs to absorb losses related to swaps transactions in the event of an affiliate default.[8] The Agencies outline several flawed arguments in favor of this change and fail to adequately consider the clear financial stability costs associated with this rulemaking.

First, the Agencies argue that in their "supervisory experience" this change would provide beneficial flexibility to banks in performing risk management related swaps transactions between affiliates and the IDI. Similar to previous deregulatory rulemakings undertaken by the Agencies recently, the proposal includes little in the way of hard data and economic analysis to justify the contemplated regulatory changes.[9] The Agencies cite their own experience throughout the proposal, essentially asking the public for blind trust. Given the broad loosening of the post-crisis framework advanced by the Agencies over the past few years, the public should rightfully view such anecdotal arguments with skepticism. In citing their own experience, the Agencies point to the potential risk-management related benefits associated with banks' concentrating their swaps portfolio in the IDI through affiliate transactions. While there may be some benefits to the centralization of these exposures, the requirement for banks to collect initial margin from affiliates does not preclude banks from engaging in such transactions. The requirement merely recognizes the enhanced risk to taxpayers and the subsidy afforded to the IDI through access to the public safety net. Also, inter-affiliate swaps transactions are often conducted with foreign affiliates that may face a less stringent regulatory framework. The risks that may emerge abroad can quickly boomerang back to U.S. shores through this type of transaction. It would be imprudent to allow banks to concentrate large exposures at the IDI without sufficient protection

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[7] Gary Gensler, "Testimony of Gary Gensler, Chairman, Commodity Futures Trading Commission before the U.S. Senate Banking, Housing and Urban Affairs Committee."

[8] Martin J. Gruenberg, "Statement by Martin J. Gruenberg, Member, FDIC Board of Directors on the Notice of Proposed Rulemaking: Swap Margin Requirements."

[9] See for example, Allison Herren Lee, "Statement of Commissioner Allison Herren Lee on Amendments to the Volcker Rule," September 19, 2019, available at https://www.sec.gov/news/public-statement/statement-lee-091919#_ftnref7 ("We have not supported or justified the choices made with evidence or analysis. Instead, the release speaks of regulators' experience in implementing the rule. But that experience is not documented in the final rule amendment so that the public can gauge whether it actually supports these changes.").

through the use of initial margin. It is critical to have loss-absorbing resources in place to protect the IDI, taxpayers, and financial stability. The benefits of removing this sensible safeguard would accrue to the banks, as they'll be able to redeploy collateral to more profitable ends. The costs of this change are reserved for taxpayers, financial stability, and the broader economy—as the risk of a destabilized banking sector would increase as a result.

Second, the Agencies point to the asset-liability pressure the inter-affiliate margin requirement places on banks, as banks increasingly look to debt markets to fund the collateral posted to the IDI. This argument mixes and misrepresents differing regulatory tools in an attempt to paint a muddled picture of the inter-affiliate margin requirements. Banks can fund margin requirements through either equity or debt. There is absolutely no requirement that banks fund the collateral through borrowing. Moreover, if regulators are concerned that banks are too frequently tapping debt markets to fund the initial margin requirements, then eliminating the requirements altogether is a strange way to mollify the concern. Instead, regulators could raise consolidated capital requirements for these institutions to directly limit the extent to which they can choose debt markets to fund their assets. Interestingly, the Agencies have actually moved to lower capital requirements for these institutions—enabling them to further increase leverage and reliance on debt markets for funding.[10] The Agencies' actions run counter to the purported leverage concern outlined in the proposal.

Third, the Agencies argue that this requirement puts U.S. banks at a competitive disadvantage internationally. This claim is easily refuted by the data. On the whole, U.S. banks have been significantly more profitable than their foreign counterparts since the crisis.[11] Over the past several years, the five investment banks with the highest fee income globally have been the investment banking subsidiaries of U.S. bank holding companies.[12] In addition, the Future Commission Merchant subsidiaries of the largest U.S. banks increased their market share from 50% to 80% between 2014-2017.[13] In fact, Comptroller Otting recently trumpeted a series of glowing statistics showing that U.S. banks have outpaced foreign banks in terms of profitability and efficiency since the crisis.[14] He even went so far as to say that U.S. banks, "returned from the brink to 'take over the world.'"[15] It is clear that the stronger regulatory framework that applies to U.S. banks relative to foreign rivals has contributed to their success. Safer and more stable banks give their clients confidence and can better provide the financial services that the broader economy needs to thrive over the course of the economic cycle.

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[10] Board of Governors of the Federal Reserve System, "Rule proposed to tailor 'enhanced supplementary leverage ratio' requirements," Press Release, April 11, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm.
[11] Martin Arnold, "How US banks took over the financial world," *Financial Times*, September 16, 2018, available at https://www.ft.com/content/6d9ba066-9eee-11e8-85da-eeb7a9ce36e4.
[12] FDIC Director Martin J. Gruenberg, "An Essential Post-Crisis Reform Should Not Be Weakened: The Enhanced Supplementary Leverage Capital Ratio," September 6, 2018, available at https://www.fdic.gov/news/news/speeches/spsep0618.pdf.
[13] Id.
[14] Joseph Otting, "The Return from the Brink and the Rise of Banks in the United States," *Int'l Banker*, November 26, 2019, available at https://internationalbanker.com/banking/the-return-from-the-brink-and-the-rise-of-banks-in-the-united-states/.
[15] Id.

Finally, the Agencies argue that other legal regulatory authorities would be more appropriate avenues for addressing the risks of inter-affiliate swaps transactions. Regulation W, which implements Sections 23A and 23B of the Federal Reserve Act, could be used to implement margin requirements on transactions between the IDI and certain affiliates. The universe of affiliates covered by Regulation W, however, is narrower than the universe of affiliates covered by the margin and capital requirements for covered swap entities rule.[16] Relying on Regulation W would therefore exclude a series of transactions with certain affiliates that are currently covered under the margin rulemaking. More importantly, the absence of a concurrent proposal to amend Regulation W reveals the hollow nature of this argument. If the Agencies genuinely thought there was a more appropriate regulatory authority or mechanism to mitigate the risk of swaps transactions between an IDI and an affiliate, they would have proposed such measures alongside this rulemaking.

**IV. The Agencies have advanced a toxic mix of deregulatory initiatives**

The elimination of the inter-affiliate margin requirement is yet another in a long string of concerning deregulatory actions taken by the Agencies.[17] It is clear that the range of proposed or finalized regulatory changes over the past several years interact with, and in some cases magnify, one another. It is not clear, however, that the Agencies have considered the compound effect of this agenda. For example, the enhanced supplementary leverage ratio ("eSLR") proposal would lower capital at the IDIs of the global systemically important banks ("G-SIBs") by about $121 billion, or 20%.[18] Over time, the proposal could lead to a capital decrease of up to $86 billion at the holding company level.[19] The removal of the inter-affiliate margin requirement would release $40 billion in loss-absorbing resources currently available to the IDI. Essentially, the Agencies may cut the overall capital requirements at IDIs substantially and simultaneously reduce the collateral available to absorb losses on swaps transactions with affiliates. Banks will seek to concentrate more un-checked swaps risk at the taxpayer-backed IDI, just as the IDIs overall capital requirements are also lowered. To make matters worse, the FDIC recently issued a proposal that would allow IDIs to rely more heavily on less stable forms of deposit funding.[20] Adding a weaker stress testing regime, a less stringent Volcker Rule, reduced living wills requirements, lighter supervision, and a host of additional deregulatory initiatives to the mix creates a recipe for disaster.

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[16] Martin J. Gruenberg, "Statement by Martin J. Gruenberg, Member, FDIC Board of Directors on the Notice of Proposed Rulemaking: Swap Margin Requirements."
[17] Gregg Gelzinis, "Tailoring Banking Regulations to Accelerate the Next Crisis" (Washington: Center for American Progress, 2019), available at https://www.americanprogress.org/issues/economy/reports/2019/05/16/469931/tailoring-banking-regulations-accelerate-next-crisis/.
[18] Peter Eavis, "Washington Wants to Weaken Bank Rules. Not Every Regulator Agrees," *The New York Times*, April 24, 2018, available at https://www.nytimes.com/2018/04/24/business/dealbook/bank-rules-leverage-ratio.html.
[19] Id.



[20] Federal Deposit Insurance Corporation, "FDIC Issues Proposed Rule on Brokered Deposit Restrictions," December 12, 2019, available at https://www.fdic.gov/news/news/press/2019/pr19121.html.

This holistic deregulatory agenda is being implemented at a time when banks are enjoying record profits and risks are building in the economy, as the expansion continues a decade after the financial crisis. This is the worst possible time to decrease the resiliency of the financial system. The Agencies should rescind the provision in this proposed rulemaking that would eliminate the requirement for IDIs to collect initial margin for swaps contracts with affiliates.

Thank you for your consideration.

Sincerely,

Gregg Gelzinis
Senior Policy Analyst, Economic Policy
Center for American Progress