Americans for Financial Reform

Hearing on “Legislative Proposals Regarding Derivatives”

U.S. House of Representatives, Financial Services Committee, Subcommittee on Capital Markets

Statement by Americans for Financial Reform

Thank you for the opportunity to submit this statement on behalf of Americans for Financial Reform.[1] Today’s hearing considers eleven different items of legislation related to over the counter (OTC) derivatives, several of them quite complex. We have not yet fully reviewed all of this legislation. However, we are deeply concerned that much of this legislation moves in the direction of reducing, and in some areas nearly eliminating, key safeguards on derivatives transactions put in place after the 2008 financial crisis. We believe weakening derivatives risk management requirements in this manner would be a serious error.

It is well known that derivatives played a crucial part in the 2008 financial crisis. However, public knowledge of this issue is often limited to the role played by credit derivatives in the collapse of the American International Group (AIG). Through one of its subsidiaries, AIG purchased over $400 billion in credit default swaps obligating it to cover losses on subprime mortgage loans, and failed to properly risk manage these derivatives. When unexpected losses and margin calls hit the company, the entire global insurance company failed, triggering a $180 billion bailout – the largest taxpayer bailout in U.S. history.

However, this is hardly the only role played by OTC derivatives in the 2008 crisis, and the 2008 crisis is not the only financial disruption where derivatives played a central role:

- The impact of Lehman’s failure in 2008 was greatly magnified by the fact that the company was a large-scale dealer in OTC derivatives, and was the counterparty to almost a million open derivatives contracts when it failed.

- OTC derivatives credit exposures unexpectedly increased by over a trillion dollars during the six months prior to the 2008 crisis. Due to poor risk management there was not adequate loss absorbency or preparation for this sharp increase in exposures, which contributed greatly to stresses on the financial system.

- Synthetic securitizations, another major contributor to the 2008 crash, were backed purely by credit derivatives. These securitizations were the most toxic of the “toxic assets” in the $640 billion market for collateralized debt obligations.

[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

- Un-capitalized and mismanaged OTC energy derivatives were the central factor in the collapse of Enron in 2001, one of the largest bankruptcies in US history and one that led to multiple criminal convictions.

- The massive increase in OTC derivatives speculation in energy markets also helped to contribute to the massive run-up in energy prices in the summer of 2008, which was followed by an oil price collapse from $147 a barrel to under $40 a barrel.[2]

This list does not exhaust the cases in which derivatives speculation was the driver of spectacular financial flameouts. For example, in 1998 the failure of Long Term Capital Management, which required Federal Reserve intervention to prevent the possible collapse of multiple systemically significant bank counterparties, was triggered by the misuse of interest rate derivatives. To take another example, in the early 1990s Orange County was bankrupted by the irresponsible use of interest rate derivatives. Over the years, derivatives have certainly lived up to Warren Buffet's famous comment that they are "financial weapons of mass destruction."

The large risks posed by derivatives are inherent and directly linked to their usefulness as instruments of risk transfer. Derivatives allow the transfer of the risk of future market price moves between different economic counterparties. This is done by tying future derivatives payments directly to future market prices. The path of future market prices is of course difficult to predict, and prices move in a particularly extreme and unpredictable manner during periods of market stress. This means that the future risk exposure from derivatives commitments is always uncertain and speculative, and can increase rapidly in times of financial stress. A seemingly small derivatives commitment today can create an enormous and unpredicted cost tomorrow. This is why it is so tempting to use derivatives as instruments of market speculation, even for commercial entities that may initially use them simply to hedge risks. And this is why it is crucial to require derivatives counterparties to responsibly manage their risks and ensure that they are prepared to make the payments that may be required of them in the future.

Unfortunately, much of the legislation under consideration by the Subcommittee today would severely and sometimes fatally weaken these risk management requirements. We believe this would be a grave error.

Industry lobbyists have consistently argued that post-crisis regulations have raised the cost of OTC derivatives transactions and therefore must be weakened or reversed. They argue this despite the fact that according to the latest data there is currently $542 trillion in notional value of derivatives globally, representing some $12.7 trillion in market value, far higher figures than ever existed before the great expansion in OTC derivatives markets that occurred prior to the

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[2] Khan, Moisin, "The 2008 Oil Price Bubble", Peterson Institute of International Economics, Policy Brief 09-19, August, 2009. https://piie.com/publications/policy-briefs/2008-oil-price-bubble

2008 financial crisis.[3] But beyond this, it is important to see that to proper goal of financial regulation is not to minimize the costs of derivatives transactions to financial market users. Prior to the 2008, derivatives were clearly underpriced, since the true risks of these contracts were not reflected in costs to users. When these risks were revealed, a massive government bailout was triggered to address the costs of previously unmanaged derivatives risks. The goal of market regulation is instead to ensure that the true risks and costs of OTC derivatives are properly reflected in the market price to users. This may result in higher costs for some users, but it ensures that the economically efficient level of risk transfer takes place and that society is protected from the fallout of another derivatives-related financial meltdown.

Below we offer comment on seven of the bills under consideration, in order of their introduction. We have not completed our review of all eleven bills, and our position on the other four bills should not be inferred from their lack of inclusion in today's hearing statement.

*H.R. 4569: To require the appropriate Federal banking agencies to recognize the exposure-reducing nature of client margin for cleared derivatives.*

This bill would require federal prudential banking regulators to revise leverage capital requirements by deducting initial margin provided by a client against a centrally-cleared derivative from the denominator of the leverage ratio. The effect of this bill would be to significantly reduce the risk absorbing capital held against losses by the giant Wall Street banks who are clearing members of major derivatives clearinghouses.

FDIC Vice-Chair Thomas Hoenig has spoken forcefully on the dangers of this approach.[4] We would also point out that there is bipartisan concern about the risk of failure of a major derivatives clearinghouse and the possibility that this could lead to a public bailout. Both the Trump Administration Treasury Department and NEC Chair Gary Cohn have expressed concern about this possibility.[5] Capital held by clearing member banks helps ensure that they can fulfill their responsibilities to the clearinghouse and is an important protection against clearinghouse failure. By reducing this capital, HR 4569 would increase the dangers of a public bailout of the derivatives market.

[3] Bank of International Settlements, "Semiannual OTC Derivatives Statistics", available at https://www.bis.org/statistics/derstats.htm
[4] FDIC Vice Chairman Thomas Hoenig, Letter to Chairman Conway and Ranking Member Peterson on margin and leverage, November 30, 2015, available at https://www.fdic.gov/about/learn/board/hoenig/hoenigletter11-30.15.pdf.
[5] Smialek, Geanna, "Gary Cohn Calls Derivatives A New Systemic Problem", Bloomberg News, October 15, 2017. https://bloom.bg/2hYM8cD

[H.R._____], *To direct the Securities and Exchange Commission and Commodity Futures Trading Commission to review and harmonize rules relating to the regulation of over-the-counter swaps. (DERIV_001)*

This bill requires the CFTC and SEC to review all derivatives-related rules and to immediately perform a joint rulemaking to harmonize any "inconsistencies" that are found.

The language of this bill has surface plausibility as a talking point, but as a statutory requirement it would be a disaster. In practice, it would be a recipe for bogging down derivatives rules in years of future debate and delay, and for undoing sensible differentiation between rules intended for different markets. Derivatives regulated by the CFTC, such as commodity, interest rate, and index derivatives, are very different than the security based swaps regulated by the SEC. In this context the meaning of an "inconsistency" is hopelessly vague.

Furthermore, this bill would require the two agencies to throw away years of work done on their current rules and re-perform joint rulemakings, a far more cumbersome and time-consuming process than a single agency rulemaking. This would create enormous confusion and uncertainty in the market, which is already adapting to current rules.

[H.R._____], *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. (DERIV_002)*

This bill would eliminate key elements of bank capital requirements in derivatives transactions with commercial end users. The "credit valuation adjustment" (CVA) requirement eliminated in this bill is the portion of capital designed to protect against the failure of a counterparty to pay its derivatives obligations. It is the key additional capital requirement for derivatives that was added in the wake of the 2008 financial crisis.

Capital is the fundamental safety and soundness protection used by banks to protect against the risk of default by a counterparty. No one would suggest that banks should not hold capital against losses when they make a commercial loan to an end user business. Exempting derivatives from key capital requirements simply because the counterparty is an end user would be just as foolish. Derivatives involve an extension of credit, and in fact a particularly risky and unpredictable credit extension since the counterparty liability may expand almost without limit based on unexpected changes in market prices.

End user derivatives counterparties are already exempted from key risk protections involving clearing and margin protections, due to concerns about their access to liquidity. Since these derivatives are exempted from other routine risk controls, capital is the remaining protection against losses on end user derivatives. It would be irresponsible for Congress to expand end user exemptions to include exemptions from capital requirements.

An excuse used for this bill is that European rules also in some cases exempt non-financial counterparties from CVA capital requirements, subject to certain thresholds. However, we should not use the European banking system – which is generally recognized as significantly undercapitalized compared to the US 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.

*H.R._____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to remove unfairness in the scope of end-user relief for end users hedging bona fide business risks, and for other purposes. (DERIV_003)*

This bill would first extend exemptions from swaps clearing provisions of Title VII that are currently limited to commercial end users to a whole new range of financial firms. Exempted entities would include unregistered commodity pools (essentially hedge funds for physical commodities) and to private funds invested in physical assets, such as funds owning real estate assets, or funds that own commercial businesses, such as private equity funds.

This change would completely tear down the distinction between non-financial operating companies and financial investment vehicles. A key part of the justification for the commercial end user exemption was that non-financial operating companies were a relatively small part of the derivatives markets, and also relatively unsophisticated compared to financial entities. It was never intended to be an exemption tied to simple ownership of any physical asset. Extending these end user exemptions to a large set of financial actors would be a grave error.

This bill would also permit certain financial affiliates of commercial entities to qualify for the clearing exemption for a so-called "de minimis" amount of purely speculative swaps activities. There is absolutely no reason to encourage commercial firms to engage in additional speculative derivatives activities in this way. If such firms wish to do speculative trading in the derivatives markets, they can do so subject to the same protections that other speculative financial entities are subject to, including clearing requirements. Furthermore, for some unknown reason, the definition of "de minimis" speculative activity in this bill as drafted appears to be based only on activity in June, July, and August, apparently meaning that financial affiliate that took the summer off from speculating in derivatives markets could argue that it qualified for exemptions on an unlimited amount of speculation during the rest of the year.

*H.R._____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to exempt swap transactions between affiliated entities from the swaps rules issued by the Securities and Exchange Commission and Commodity Futures Trading Commission. (DERIV_005(2))*

This legislation would exempt swaps between affiliated entities from coverage under CFTC and SEC swaps rules. Given the scope and complexity of multinational financial institutions that have affiliates in numerous countries around the world, this is an extraordinarily dangerous approach. Swaps between affiliates can be used to move risk around the world in ways that effectively transfer derivatives to unregulated foreign jurisdictions.[6] A blanket exemption for inter-affiliate swaps would permit almost unlimited evasion of core swaps regulations.

The legislation itself appears to recognize this danger, and after granting a sweeping exemption from regulation for inter-affiliate swaps, it then stipulates in general terms that several swaps protections such as risk management, reporting requirements, variation margin, and anti-evasion provisions shall continue to apply. This would apparently require the CFTC and SEC to effectively eliminate all its current rules as they apply to inter-affiliate transactions, then rewrite these rules around the vague and general instructions in this bill. This is a recipe for a confusing multi-year process of rule rewriting which would be challenged by litigation and lawsuits at every step based on the statutory language of this bill.

The CFTC and SEC have already undergone a lengthy multi-year process of determining the cases in which inter-affiliate swaps will be subject to regulation and the situations under which they will be exempted. Swaps rules already contain a wide range of exemptions for inter-affiliate transactions. Indeed in a number of cases the CFTC has gone well beyond the level of exemption considered prudent by other regulators, in some cases irresponsibly so.[7] If industry lobbyists have issues with current CFTC rules they should make these issues clear rather than attempt to create a dangerously overbroad exemption from rules for all inter-affiliate swaps.

*H.R._____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to encourage risk mitigation by excluding all hedging swaps from the swap dealer de minimis threshold, and for other purposes. (DERIV_007)*

This bill excludes from the *de minimis* swaps calculation which triggers swap dealer registration any and all swaps that the entity uses to hedge commercial risk. Crucially, this statutory exemption specifies that swaps which manage risks arising out of the entity or its affiliates' swaps dealing activities would also be excluded from the *de minimis* calculation.

Granting this potentially vast exclusion is a recipe for fatally weakening swap dealer designation and ensuring that even large and systemically risky derivatives dealers are not required to register as swap dealers. Swap dealers always attempt to maintain a relatively balanced book so they are not overly exposed to market risk. It is thus inherent in the swap dealer business model that almost any swap can be claimed to hedge the risk from another swap. Derivatives dealers would be able to use this overbroad exemption to claim that literally trillions of dollars in notional swaps value must be excluded from consideration for dealer designation on the basis that these swaps were hedging commercial risks arising from dealer activities. It is obvious that an entity should not be permitted to claim exemption from dealer designation based on the

[6] See for example the discussion and definition of "conduit affiliate" in the CFTC's final cross border guidance, available at http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2013-17958a
[7] See e.g. the 2015 AFR letter to the CFTC regarding inter-affiliate exemptions from derivatives margin rules, available at http://ourfinancialsecurity.org/wp-content/uploads/2015/12/AFR-CFTC-Margin-Letter-2.pdf

argument that its activities as a dealer should not be taken into consideration. Yet this is the circular logic that would be permitted by this bill.

Furthermore, risk management at swaps dealers is not solely designed to protect dealers from market risks, which is the purpose of hedging. Another central purpose is to ensure that dealers have sufficient loss absorbency in place to protect themselves against the risk of counterparty default. Major dealers are systemically significant because if a counterparty default leads to the failure of a dealer, this will harm numerous other counterparties to the dealer who had nothing to do with the initial default. Hedging market risks does nothing to protect against the risk of counterparty default, and the fact that a dealer engages in hedging in no way reduces the need to ensure that they are protected against counterparty default.

Major swaps dealers play a central role in the derivatives markets, and ensuring that risks are properly controlled at these dealers is crucial to any attempt to regulate derivatives markets. This bill would create an enormous back door that such dealers could use to escape designation.

*H.R._____, To provide clarity regarding the de minimis exception annual thresholds for swap dealers and security-based swap dealers, and for other purposes. (Deriv_008)*

This bill expands the *de minimis* exemption from derivatives dealer designation to $8 billion in the CFTC's markets and $400 million in the SEC's markets.

The $8 billion *de minimis* exemption in the CFTC's rules was only meant to be a temporary transitional measure to allow markets to adjust, not a permanently high threshold. A blanket exemption at the $8 billion notional level is much too high for many markets. As pointed out by Andrew Green in his written testimony today, the block trading rules already passed by the CFTC, which define the size of a large block trade, give insight into the fundamental differences between meaningful trade sizes in different markets. For example, the $8 billion trade size would represent about seven large trades in the interest rate markets, about 67 large trades in the credit default index market, and about 2,666 large swaps in the commodity crude oil markets. [8]

The CFTC and SEC should be left to tailor the *de minimis* exemption to its appropriate level for the relevant market. Part of this regulatory effort should be moving on from the current transitional $8 billion level, as $8 billion is inappropriately high for most markets and not properly tailored to the nature of different markets.

Thank you for the opportunity to submit this hearing statement. Should you have questions, please contact AFR's Policy Director, Marcus Stanley, at 202-466-3672 or marcus@ourfinancialsecurity.org.

[8] See 17 CFR Appendix F to Part 43, "Initial Appropriate Minimum Block Sizes by Asset Class for Block Trades and Large Notional Off-Facility Swaps."