December 9, 2019

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RE: Margin and Capital Requirements for Covered Swaps Entities (OCC Docket ID OCC–2019–0023; Federal Reserve Docket No. R–1682; FDIC RIN 3064-AF08)

To Whom It May Concern:

The Americans for Financial Reform Education Fund (AFR Education Fund) appreciates the opportunity to comment on the above referenced Proposed Rule (the "Proposal") concerning margin and capital requirements for Covered Swaps Entities (CSEs) by the various prudential regulators (the "Agencies"). Members of the AFR Education Fund include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

We strongly oppose the Agencies proposal to remove requirements to post initial margin when engaging in inter-affiliate derivatives transactions with covered swaps entities. The Agencies instituted this requirement just four years ago, concluding that these margin postings were necessary to "protect the safety and soundness of the covered swap entity in the event of an affiliated counterparty default".[2] Since the CSEs addressed by this proposal include the key depository affiliates of the largest U.S. banks – entities at the heart of the taxpayer-supported safety net for systemically critical banks – the 2015 Final Rule also concluded that failing to require initial margin for inter-affiliate swaps would pose a threat to broader systemic stability.

Now, a few years after the Agencies clearly affirmed the significance of initial margin protections for inter-affiliate swaps, this decision is being reversed before margin rules have even

[1] A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/
[2] Margin and Capital Requirements for Covered Swaps Entities, Final Rule, Federal Register, Volume 80, No. 229, November 30, 2015, 74840-74912. https://bit.ly/2PxtEfP

been fully implemented. The justifications given for this dramatic reversal in the proposal are completely inadequate and lack justification or backing, as explained below.

Justification #1: "supervisory experience has shown that inter-affiliate swaps are used by covered swap entities for internal risk management purposes whereby a banking organization transfers risk to a centralized risk management function, which is considered to be a prudent risk management practice", and removal of initial margin requirements will grant more flexibility for such risk management.[3]

It was well known by the Agencies at the time of the 2015 rule that large international banks used inter-affiliate swaps for internal risk management purposes, this is not new information. Indeed, the "internal risk management" justification for an initial margin exemption was explicitly considered and rejected in the 2015 rule.[4] No reason is given in this Proposal beyond a vague reference to "supervisory experience" for why "internal risk management" is now deemed sufficient justification to completely reverse the 2015 decision to require posting of initial margin for derivatives transactions with CSEs.

More broadly, the issue here, as explained in the 2015 rule, is not simply risk management but the balance between risks to the solvency of critical "too big to fail" depository subsidiaries within the taxpayer insured safety net, and the ability of banks to transfer derivatives risks internally to such subsidiaries without the cost of initial margin. Clearly initial margin itself is a critical form of risk management. To justify eliminating requirements for risk management through margin, the Agencies must explicitly weigh the benefits of more margin protections for CSEs against the supposed benefits of making it easier to transfer derivatives risks between subsidiaries of large international banking organizations. No such analysis is evident in the Proposal. Furthermore, if the reason for transferring such risks is, for example, to benefit from the pricing advantages of locating derivatives within the U.S.-insured depository subsidiary, this is not simply "risk management" but an effort to take advantage of a taxpayer subsidy, a subsidy which should be properly priced through the use of margin postings.

Justification #2: "affected banking organizations…borrow increasing amounts of cash in the debt markets to fund eligible collateral, placing additional demands on their asset-liability management structure and increasing their liability exposure"

Once again, the possibility that banks may borrow money for collateral was well known at the time of the 2015 rule and no reason is given as to why it now justifies reversing the 2015 rule.

More importantly, the ability of banks to borrow is directly regulated by the Agencies through capital requirements, and the appropriate response to a concern that banks are borrowing excessively is to force them to set aside more equity capital through capital rules or stress testing. The Agencies are currently doing precisely the opposite of this, for example by proposing to

[3] Proposal at CFR 59976
[4] CFR 74888, Margin and Capital Requirements for Covered Swaps Entities, Final Rule, Federal Register, Volume 80, No. 229, November 30, 2015, 74840-74912. https://bit.ly/2PxtEfP

reduce the required minimum leverage ratio for the same large banks affected by this rule.[5] Ironically, less than a month ago the Agencies also explicitly loosened capital requirements for large bank derivatives exposures, thus permitting banks to run their derivatives business at higher levels of leverage.[6] These recent choices are not indicative of any regulatory concern about excessive borrowing by banks active in the derivatives market, quite the opposite. They suggest that the concern about leverage expressed in this Proposal is simply an excuse for permitting lower levels of margin to be held internally against derivatives risks.

Justification #3: "because other jurisdictions (as well as U.S. market regulators) do not consistently apply swap margin rules to inter-affiliate swaps, the Rule's imposition of initial margin requirements for inter-affiliate swaps may have limited systemic risk benefits and put U.S. firms at a competitive disadvantage"

With this justification, the Agencies explicitly embrace a race to the bottom logic that would require the U.S. to lower standards to match inadequate regulation elsewhere. The proper response to inadequate regulations in foreign jurisdictions is to ensure high standards are enforced through U.S. rules on financial activities that have a significant impact on the U.S. economy. That is especially important for banking subsidiaries, like the covered swaps entities in this proposal, which include large depository institutions within the U.S. safety net.

Beyond that general point, the specific claims made in this justification are of doubtful validity. The Agencies claim that U.S. banks are in danger of being placed at a meaningful competitive disadvantage by margin rules. Yet just a few weeks ago Comptroller Otting, in an article in the International Banker, stated that "banks in the United States are as healthy as they have been at any point in my 35-year career" and "have flexed their competitive muscle", with twice the return on equity of European banks and a commanding share of 60 percent or more of global investment and merger fees.[7] Given that until recently U.S. banks were being held to stronger rules than banks in other advanced countries, it is likely that strong prudential requirements actually have contributed to the dominant competitive position of U.S. banks.

In addition, the 2015 margin rule was explicitly written to apply to CSEs that were controlled foreign subsidiaries of U.S. parent companies. The Commodity Futures Trading Commission similarly applies margin rules to controlled foreign subsidiaries. It is thus unclear whether or to what extent foreign subsidiaries of major U.S. banks would be governed by foreign rules, which do not require the posting of initial margin for inter-affiliate swaps, instead of the U.S. rule. If

[5] Regulatory Capital Rules: Enhanced Supplementary Leverage Ratio Standards, Proposed Rule, Federal Register, Volume 83, No. 76, April 19, 2018, 17317-17327. https://bit.ly/35bBKRN

[6] Joint Press Release, "Federal Bank Regulatory Agencies Finalize Rule to Update Calculation of Counterparty Credit Risk for Derivative Contracts", November 19, 2019, at https://bit.ly/36rDZ3T; Statement by Martin J Gruenberg, Member, FDIC Board of Directors, Re Final Rule: Standardized Approach for Calculating the Exposure Amount of Derivatives Contracts, November 19, 2019, at https://bit.ly/2t5uMjj

[7] Otting, Joseph, "The Return From the Brink and the Rise of Banks in the United States", International Banker, November 26, 2019; at https://bit.ly/2PvtDcg

U.S. rules would apply, then the existence of differing foreign rules would not reduce the systemic risk benefits of a strong U.S. rule.

Justification #4: "almost all U.S. Covered Swap Entities are insured depository institutions that would be subject to Section 23A, 23B, and Regulation W…the agencies believe that they are the more effective tools to address risks arising from transactions between affiliates"

Protecting depository subsidiaries from derivatives risks originated in non-bank affiliates is a central reason to maintain initial margin requirements. We would certainly welcome strong enforcement of Section 23A and 23B. But it is not credible that the Agencies would remove existing requirements for initial margin postings to depository banks and then re-establish equivalent protections under Section 23A and 23B. If the Agencies intended to do this, then they would simply maintain margin protections for insured depository institutions in this Proposal.

Indeed, this Proposal already arguably violates Section 23B of the Federal Reserve Act. Section 23B(a)(1) states that a bank may only engage in covered transactions (including derivatives transactions) with an affiliate "on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies". Since initial margin is generally required for un-cleared transactions with nonaffiliated companies, this Proposal would seem to violate Section 23B because the margin exemption does not maintain affiliate transactions on terms which are "substantially the same" as comparable transactions with non-affiliates.

In addition, the Federal Reserve Board has a long history of granting exemptions to Section 23A and 23B firewalls, almost on demand. The record of exemptions granted to banks for statutory requirements since the passage of Gramm-Leach-Bliley offers no confidence at all that the Board will protect insured depository institutions from derivatives risks through the enforcement of these sections, in the absence of a clear and direct requirement that affiliates post initial margin when transferring derivatives risks to depositories.[8]

In sum, we strongly oppose the Agencies proposal to eliminate initial margin posting for inter-affiliate derivatives transactions with prudentially regulated bank subsidiaries. We consider the justifications offered for this step to be totally inadequate and urge the Agencies not to take it. Thank you for the opportunity to comment on this Proposal. If you have questions, contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org

Sincerely,
Americans for Financial Reform Education Fund

[8] Omarova, Saule T., "From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act", North Carolina Law Review, Vol. 89, 2011; UNC Legal Studies Research Paper No. 1828445. Available at SSRN: https://ssrn.com/abstract=1828445. See also Ivry, Bob and Hugh Son, "BofA Said to Split Regulators Over Moving Merrill Contracts", Bloomberg Economics, October 18, 2011. https://bloom.bg/2seDLhA