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November 24, 2014

The Honorable Thomas Curry
Office of the Comptroller of the Currency, Treasury

The Honorable Janet Yellen
Board of Governors of the Federal Reserve System

The Honorable Martin Gruenberg
Federal Deposit Insurance Corporation

The Honorable Jill Long Thompson
Farm Credit Administration (''FCA''); and

The Honorable Melvin Watt
The Federal Housing Finance Agency

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Re: Margin and Capital Requirements for Covered Swap Entities

Dear Officers,

On behalf of more than 350,000 members and supporters of Public Citizen, we hereby submit the following comments regarding the proposed rule governing Margin and Capital Requirements for Covered Swap Entities. This proposal implements Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

We believe the proposed rule falls well short of meeting the statutory requirement that requires capital and margin for all non-cleared swaps. The agencies' proposal could open the door for a complete escape from US supervision—and even comparable supervision by foreign regulators—if a US firm establishes a non-guaranteed affiliate incorporated in a foreign nation. With end users, the agencies openly allow banks to shed the use of margin collateral which can expose the financial sector to unnecessary risk. Finally, we take issue with the frequently repeated goal behind these permissions, namely, to promote the competitiveness of US banks, which we believe is misguided and lacks statutory basis.

Overview

The 2008 financial crisis revealed reckless derivatives speculation by a number of major firms that led to a massive taxpayer bailout. As the agencies note in the proposal, these firms had "taken on excessive risk through the use of swaps without sufficient financial resources to make good on their contracts."[1] At AIG, financial regulators extended $185 billion in bailout loans to cover bets made through credit default swaps originated by a London affiliate of the firm. For context, the budget of the state of California is $154 billion.

The 2008 crisis demonstrated that uncollateralized derivatives expose the financial system to several types of risk. It introduces uncertainty where market players cannot be sure that their counterparties can cover their exposure. They pose a threat to individual market participants. And they increase systemic risk, as the failure of one participant can jeopardize others. Further, lack of collateralization promotes risk-taking, as speculation becomes unfettered from needed safety measures.

Congress approved many reforms designed to prevent such bailouts in the future. Sections 731 and 764 of the Dodd-Frank Wall Street Reform Act constitute two such reforms. The agencies' proposal is offered as implementing these sections.

Sections 731 and 764 provides for the registration and regulation of swap dealers and major swap participants overseen by the Commodity Futures Trading Commission and the Securities and Exchange Commission respectively. These agencies shall decide what swap dealers and participants must register. Those that are banks shall be subject to regulation by respective prudential regulators. For bank swap dealers, the regulators must establish "capital requirements; and both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization." The statute mandates that the regulators must establish margin requirements that are consistent with "preserving the financial integrity of markets trading swaps; and preserving the stability of the United States financial system."

This rule would govern an enormous market. Even though Congress intended to promote standardized, central clearing and exchange trading of swaps, data shows that the overwhelming share of swaps remain bilateral contracts transacted "over-the-counter" (OTC). As of December 2013, the notional value of global OTC swaps was $710 trillion.[2] By contrast, the volume of exchange traded derivatives

[1] Federal Register, p. 57351 (September 24, 2014), available at: http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf

[2] These swaps had a gross market value of $18.6 trillion. Bank of International Settlements, (2013); available at: http://www.bis.org/statistics/dt1920a.pdf

stood at $30 trillion as of June 2014.[3] At JP Morgan, for example, 96% of its swaps book is OTC, while only about 4 percent is exchange traded. The bank's derivatives book was $67 trillion, more than a third of all US bank derivatives holdings.[4] It is imperative that this enormous market be overseen with the strictest prudential standards.

Regulators should be mindful in any economic consideration that this market is largely one involving bank contracts with other banks. Some products, such as the credit default swap, played a clearly detrimental role leading to the financial crisis, in that they created the appearance of risk mitigation, when, in fact, these products served to amplify risk.[5] Swaps between financial entities should be considered with skepticism, as part of a zero sum game of gambling. Sarah Bloom Raskin, currently the Deputy Treasury Secretary, characterized traffic in such vehicles as swaps "as an activity of low or no real economic value."[6] Derivatives expert Bruno Dupire concluded: "The social utility of derivatives has been globally negative."[7]

The Bank for International Settlements Semi-Annual Survey on Derivatives shows that less than 10% of the market is traded between dealers and their non-financial end-user customers. [8] In the foreign exchange derivatives market, which might be viewed as helping promote international trade, end users only represent about a sixth of the total volume. [9] Even in the real world economy, bilateral swaps are unevenly embraced. In the airline industry, there is no exchange trading for derivatives in jet fuel. Firms that wish to hedge their jet fuel costs must use proxies, such as oil. Many firms do not hedge. A British Airways executive explained that over the long term, the cost of fuel must be borne as an expense, and that smoothing swings through hedging in jet fuel prices is a net loss, owing to the fees required for hedging.[10]

In commodities, speculators represent a major share of the market, and studies show that schemes can drive up food prices. [11] Other swaps have been vehicles for manipulation of many underlying commodity prices.[12] Critics contend that excessive speculation by financial institutions in commodity derivative

[3] Bank of International Settlements (2014), available at: http://www.bis.org/statistics/r_qa1409_hanx23a.pdf

[4] OCC's Quarterly Rep[ort on Bank Trading and Derivatives Activities (2014), available at: http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq114.pdf

[5] See Financial Crisis Inquiry Commission report.

[6] http://www.federalreserve.gov/newsevents/speech/raskin20120723a.htm

[7] "Derivatives have had negative social utility," Risk (July 2013), available at: http://www.risk.net/risk-magazine/news/2283218/quant-congress-usa-derivatives-have-had-negative-social-utility-says-dupire

[8] See pages 17-20 of report at: http://www.bis.org/publ/otc_hy1011 Bank for International Settlements, available at: See pages 17-20 of report at: http://www.bis.org/publ/otc_hy1011

[9] Bank of International Settlements, available at: http://www.bis.org/publ/otc_hy1405.pdf

[10] "Jet Fuel Hedging Strategies," by Richard Cobb et all, Kellogg School of Business (2004), available at: https://www.kellogg.northwestern.edu/research/fimrc/papers/jet_fuel.pdf?origin=publication_detail

[11] "Excessive Speculation in Agriculture Commodities, Institute for Agriculture and Trade Policy (2011), available at: http://www10.iadb.org/intal/intalcdi/PE/2011/08247.pdf

[12] For a survey of studies, see: http://www.iadb.org/intal/intalcdi/PE/2011/08247.pdf

issues in June 2008 led grain elevators to stop forward contracting with farmers and rural banks stopped loaning to elevators. [13]

In short, the agencies should oblige the statutory mandates without regard to whether safeguards might reduce the opportunity for banks to secure rents from derivatives activity.

The Agencies' proposal makes several references to the "competitiveness" of US firms. For example, the Agencies intend "to limit the extraterritorial application of the margin requirements while preserving, to the extent possible, competitive equality among U.S. and foreign firms in the United States." The agencies do not define what is meant by "competitive equality" or why they have adopted this intention. We speculate that a US bank that is competitive with foreign peers is one whose business grows in a particular market where it faces peer competition.

Should the regulators be concerned about competitive disadvantage? This might be a defensible goal if American banks operated exclusively with American employees through American-based operations, generated dividends exclusively for American stockholders, met bond interest obligations to American bondholders, and paid taxes only to the US Treasury. It is the Fed's mandate to promote US employment. However, many of the larger banks headquartered in the United States maintain prodigious foreign operations staffed by foreign nationals, pay dividends and interest to non-US citizens, and pay taxes to foreign governments. The largest shareholder of Citigroup is the nation of Abu Dhabi. JP Morgan operates in 60 countries with non-US employees.

While we don't contest such cosmopolitan dynamics here, we also don't believe US regulators should sacrifice prudential regulation to help US firms benefit foreign workers, shareholders and government treasuries under the banner of "competitive equality."

We believe the statute provides no basis for such a goal. The statute's only goal is to promote the safety and soundness of the institutions, as noted above.

Cross border

The agencies proposed rule contains a clear path for US firms to evade the mandate of Dodd-Frank prudential oversight through the establishment of foreign-incorporated affiliates.

The proposed rule provides that a foreign-incorporated swaps dealer that is a subsidiary of a US parent and where the US parent provides no guarantees will be exempt from the agencies' margin rules. Section (9)(b) provides that US margin rules will apply to US-incorporated firms, a branch of such a firm even if located abroad, and to what is termed "covered swap" firms. Section 9(b)(3) states that "*A covered swap entity* that is controlled, directly or indirectly, by an entity that is organized under the laws of the United States or any State" would be subject to the US margin rules. What is a covered swap entity? According to Footnote 119, a covered swap entity is one defined by the relevant prudential regulator. In this case, the defining agency is the CFTC. According to the CFTC's guidance on cross-border

[13] See comment letter of Dr. Steve Suppan, IATP, available at: http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2014/06/HR-4413-Lobby-Letter-IATP-REV.pdf

swaps, foreign-incorporated “affiliates” of US parents are *not* considered “US Persons,” and therefore *not* “covered” by US rules. [14]That is, such entities do not meet the CFTC’s definition of a “covered swap entity.” [In the CFTC case, this also applies to foreign-incorporated affiliates where the US parent guarantees the swaps. The Agencies’ proposed Section 9(d), however, states that US rules do apply where either counterparty is guaranteed by a US-incorporated firm. Hence, only the non-guaranteed swaps of a foreign-incorporated subsidiary of a US parent would escape the margin rules.]

Moreover, these foreign-incorporated affiliates may escape comparable regulation by a foreign government. In Section 9(d)(1), the proposed rule provides that “covered swaps” may be eligible for “substituted” compliance. But “covered swaps” do not include those defined by the CFTC as non-US persons, that is, as swaps from a foreign-incorporated affiliated of a US parent. Only foreign-incorporated affiliates guaranteed by a US parent would be either supervised under US margin rules or eligible for substituted compliance by the relevant foreign government if the regulation were determined to be comparable.

We believe this constitutes a dangerous path by which US banks can escape appropriate supervision. For example, the US parent could establish a subsidiary incorporated in the Cayman Islands. Provided the US parent provides no guarantee, they would only be subject to any supervision that the Cayman’s government chose. US regulators would not need to determine that the Cayman regulation was comparable. In fact, even if US regulators found the Cayman oversight entirely inadequate, this affiliate would be free of any US margin and capital requirements.

This evasionary vehicle does not seem to be unintended or an oversight, but well understood by the agencies. The agencies note, “a substantial amount of swaps activities are currently conducted through foreign subsidiaries that *may not* be subject to certain elements” of the rule. “The risks of such foreign activities could be borne by insured depository institutions.” The FDIC, in other words, may be liable for unsupervised, high risk swaps trading.

Evasion is not far-fetched. In 2014, firms have begun to “de-guarantee” these swaps. [15] We are somewhat encouraged that regulators have at least expressed concern about this evasionary tactic.

We urge in the strongest terms that this escape route be closed. Most simply, the agencies should delete the word “covered” in Section 9(b)(3). [We are pleased that the same construction does not apply to security-based swaps, where the proposed rule would require margin for “an entity controlled” by a US firm.]

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[14] According to the guidance: “Under the proposed interpretation, a “U.S. person” would include a foreign branch of a U.S. person; on the other hand, a non-U.S. affiliate guaranteed by a U.S. person would not be within the Commission’s interpretation of the term “U.S. person.” Available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071213b.pdf

[15] “Big US Banks Make Swaps a Foreign Affair,” by Katy Burne, Wall Street Journal, (April 2014); Available at: http://online.wsj.com/news/articles/SB10001424052702304788404579520302570888332

Short of this change, we believe that the intent of Dodd-Frank swaps reform will be undermined.

The absence of a guarantee, which allows US firms to escape prudential regulation, does not insulate the American taxpayer from exposure in the event of a major bank failure. The government has consistently bailed out firms regardless of legal domicile. The US taxpayer actually provided bailout relief to foreign firms such as Deutsche Bank under the justification that broken contracts would lead to greater economic turmoil.

Foreign margin rules comparable to US margin rules are better than no margin rules. But such comparable rules may be inadequate. Comparable regimes may lack adequate enforcement, as catastrophic problems would be borne by US, not foreign taxpayers. Indeed, it will be in the interest of a foreign government to make enforcement "friendly" to business, as it generates wanted tax revenue. In Britain, for example, the banking sector accounts for substantial tax revenue.

End User Margin Requirements

The agencies appropriately note that the statute requires margin rules for all non-cleared swaps. Commercial end-users are not expressly exempted. [16] Without explanation or justification of the prudence of exempting end users from any specific margin requirement, the agencies then propose to do just that.

We believe this violates the letter of the statute. Dodd-Frank Section 731 in (d)(B)(2)(A) provides that prudential regulators shall jointly adopt rules imposing capital requirement and both initial and variation margin requirements "on ALL swaps" that are not cleared by a registered derivatives clearing organization. (Capitalization added.)

In adopting these mandatory margin requirements for all swaps, the statute explains in (d)(B)(2)(C) that the goal is to help "ensure the safety and soundness of the swap dealer or major swap participant."

We recognize that end users have proffered comment claiming that a) end user swap activity did not contribute to the 2008 financial crisis; and b) margin would unnecessarily sideline capital that could otherwise be used for job-generating growth.

While such justification is beside the point given the clear statutory language, the agencies should not succumb to these dubious arguments.

Traditional end users may not have been central to the financial crash of 2008, but their failure can still pose risk to the banking system in future. Some of the larger recent bankruptcies have involved firms active in the swaps market, such as Enron and Calpine.[17] Currently, three major commodities firms are registered as swap dealers with the CFTC: BP Energy Company, Shell Trading Risk Management LLC, and

[16] Federal Register, p. 57458 (Sept. 24, 2014), available at: http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf
[17] "Is it an Enron Twin?" by Gretchen Morgenson, New York Times (December 9, 2001), available at: http://www.nytimes.com/2001/12/09/business/is-it-an-enron-twin-or-just-a-look-alike.html

Cargill Incorporated. [18] An end user whose swaps book exceeds that of its peers may be attempting to profit from swaps speculation instead of recognizing swaps as an expense in order to manage risk. Enabling such speculation should not be considered an agency mandate or priority. Currently, swaps enjoy privileges in bankruptcy court whereby the margin can be seized ahead of the court's delegation of funds to other creditors. Without margin collateral, however, the bank would be exposed to the same delay and prospect of reduced payment as many other creditors. [We note that regulators are appropriately seeking that the International Swaps and Derivatives Association master contract be amended so that the so-called early termination rights where margin can be collected be temporarily suspended. We do not anticipate, however, that the industry will forfeit these privileges altogether, which would otherwise require a welcome act of Congress.]

In practice, roughly 90 percent of all global uncleared derivative trades contain collateral agreements that serve a similar function as margin, according to a survey by the International Swaps and Derivatives Association. [19] As with margin, the collateral typically is either cash or government securities, which account for 90 percent of the collateral. The amount of such collateral was more than $3 trillion, as of a recent survey. Those who argue that real economy firms shouldn't be required to tie up capital in swaps deals ignore this reality. Moreover, regulators should also recognize this and codify it in the final rule.

Banks that don't require end users to post margin explicitly are certainly not making interest-free loans. It is likely that a bank will imbed any greater risk from the absence of concrete margin or other collateral agreements in the price of the swap. This additional price would be identical to the interest cost on a loan that the end user could secure for cash margin. Where a bank may not require margin, the agencies' correctly described this as an "unsecured loan." No prudent bank would engage in a swap without examining the ability of the end-user to make good on any future payments. That is, the bank looks to assets of the end user that it might recognize as de facto margin collateral. Those assets must already be free of liens from any other creditor. This can be thought of as a contingent line of credit. Were this contingent line of credit not associated with the swap, it could be used for other purposes of the end user. Professors John Parsons and Antonio Melo explore this financial reality. [20] Financially, they explain, margin "does not change the total financing or capital that the non-financial corporation requires to back its hedging."[21]

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[18] See CFTC, (visited Nov. 3, 2014), available at: http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer, or Dodd-Frank.com (visited Nov. 3, 2014), available at:L http://dodd-frank.com/who-are-the-swap-dealers/

[19] "Margin Surveys," produced by ISDA (Website visited November 7, 2014) Available at: http://www2.isda.org/functional-areas/research/surveys/margin-surveys/

[20] "Margins, Liquidity and the Costs of Hedging," by John Parsons and Antonio Mello (May 2012); available at http://web.mit.edu/ceepr/www/publications/workingpapers/2012-005.pdf

[21] In Congressional Testimony, Prof Parsons explains: It is easy to misunderstand the relationship between the practice of margining and the cost of trading derivatives. Because the credit risk in a non-margined derivative is embedded in the derivative, and because the cost is paid implicitly through the price terms for the derivative, it is easy to overlook the cost. The practice of margining forces a separate accounting for the credit risk and makes the cost paid for this credit risk explicit. Consequently, many people mistakenly think that the practice of margining creates a new cost. This misunderstanding shows up in the memorandum prepared by the Committee Staff in preparation for this hearing. That memo states that "imposing margin requirements on end-users that

End users that do not post margin effectively place the margin liability off the balance sheet, out of view to investors. We believe this is deceptive and reduces the ability of investors to serve as de facto prudential guardians of major firms. The Council of Institutional Investors, an association of investment funds with formidable equity holdings, concurs with this view. [22]

General margin issues

Beyond these two overriding concerns, we offer the following brief comments on a miscellany of issues.

- While we do not endorse the initial margin threshold of $65 million, we do support that this minimum only be subtracted from separate legally enforceable eligible master netting agreements (EMNAs) with three counterparties even if they belong to a larger consolidated group.
- We support the safekeeping of collateral that bars rehypothecation, re-pledging, or reuse such as in repurchase agreements.
- We support the agencies' proposal to require both collection and posting of margin, a substantial improvement over the 2011 proposal.
- We support the proposed requirement for initial and variation margin for uncleared swaps between affiliates.
- We support the mandatory use of a third-party custodian.
- We support the incentives implicit in the the proposed rule that may encourage more use of central clearing. The proposal requires margin calibration over a 10 day period of risk, whereas cleared swaps measure only over five days. The result is that non-cleared swaps will face margin requirements about 40 to 45 percent higher than cleared swaps, according to Federal Reserve staff estimates. Such greater costs will encourage the swap dealer to use central clearing.[23]

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are not financial firms would divert capital from operating budgets, leaving end-users with less capital from operating budgets, leaving end-users with less capital for investment and job creation." This claim is simply not true. Margin requirements do not drain a company's capital. If a company has enough debt capacity that the derivative seller will extend it the implicit line of credit, the company also has enough debt capacity that a bank or other financial institution will extend it the explicit line of credit to fund the required margin. A requirement to margin derivatives does not drain any capital from non-financial companies: instead, the requirement only forces the credit to be extended explicitly. The amount of credit required to trade the derivative is determined by the company's specific risks, by the specific risks of the derivative, and by their interaction. The practice of margining does not change or add to the capital requirement.. House financial services committee, (December 12, 2012), available at: http://financialservices.house.gov/uploadedfiles/hhrg-112-ba16-wstate-jparsons-20121212.pdf

[22] Council of Institutional Investors, comment letter, available at: http://www.federalreserve.gov/SECRS/2011/June/20110624/R-1415/R-1415_062211_81353_413848970611_1.pdf

[23] Federal Reserve staff presentation (Sept. 3, 2014), available at: http://www.sifma.org/members/hearings.aspx?id=8589950772

Thank you for your consideration. For questions, please contact Bartlett Naylor at bnaylor@citizen.org, or 202.580.5626,

Sincerely,

Public Citizen.