

Proposal: 1682 (7100-AF62) Margin and Capital Requirements for Covered Swap Entities  
Description:

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Comment ID: 137097

From: Elliot MacDonald

Proposal: 1682 (7100-AF62) Margin and Capital Requirements for Covered Swap Entities

Subject: Margin and Capital Requirements for Covered Swap Entities

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Comments:

Date: Dec 08, 2019

Proposal: Margin and Capital Requirements for Covered Swap Entities [R-1682]

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Your comment: December 8, 2019

Chief Counsel's Office

Attention: Comment Processing

Office of the Comptroller of the Currency

400 7th Street, S.W.

Suite 3E-218

Washington, D.C. 20219

Docket ID OCC-2019-0023

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Secretary

Board of Governors of the Federal Reserve System

20th Street and Constitution Avenue, N.W.

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Docket No. R-1682; RIN 7100-AF62

Robert E. Feldman

Executive Secretary

Attn: Comments/Legal ESS

Federal Deposit Insurance Corporation

550 17th Street, N.W.

Washington, D.C. 20429

RIN 3064-AF08

Barry F. Mardock, Deputy

Director, Office of Regulatory Policy,

Farm Credit Administration, 1501 Farm  
Credit Drive, McLean, VA 22102-5090.

Alfred M. Pollard, General Counsel,  
Attention: Comments/RIN 2590-AB03,  
Federal Housing Finance Agency,  
Constitution Center (OGC Eighth Floor),  
400 7th St. SW, Washington, DC 20219  
RIN 2590-AB03

Re: Margin and Capital Requirements for Covered Swaps Entities

Dear Ladies and Gentlemen:

Thank you for your time and diligence in considering how to make our great nation's financial system safer, more efficient and more productive. Thank you also for the opportunity to comment on the well thought out and considered proposed rules referenced above. My comments pertain to just one aspect of the proposed rule, namely the repeal of the inter-affiliate initial margin provisions. Such a repeal, while well intended, is (as demonstrated by recent historical precedent) likely to open the door to the build-up of financial risk for which adequate capital and margin will be lacking. This repeal would expose our great nation's financial system and, as we saw from the recent financial crisis, much of our nation's citizenry to the risk of a similar crisis in the future. As the recent financial crisis demonstrated, an entire inter-linked and interdependent financial system can teeter when weak links are allowed populate the system; particularly if those weak links are part of, or affiliated with, the system's most important players. Many, if not all, of the financial institutions that failed (or would have failed had it not been for the extraordinary financial intervention of governments and central banks), were put in peril as the result of the risk positions of affiliates.

As noted in the proposed rule:

"the requirement to collect initial margin from, but not post initial margin to, affiliates 'should help to protect the safety and soundness of covered swap entities in the event of an affiliated counterparty default.' Furthermore, by requiring that inter-affiliate swaps be margined, the requirement was intended to prevent un-margined swaps from posing a risk to systemic stability." (84 FR 59975-76, November 7, 2019)

These concerns and goals remain just as relevant today as they were when rule now being considered for repeal was adopted.

The proposal also states that:

"Since the Swap Margin Rule was implemented, 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. As more covered swap entities have come into scope, the amount of inter-affiliate initial margin collected by covered swap entities has increased. This has led the affected banking organizations to 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 to depositors and other creditors in the market. The removal of the inter-affiliate initial margin requirement would provide these banking organizations with additional flexibility for internal allocation of collateral." (84 FR 59976)

While it may be correct that the "removal of the inter-affiliate initial margin requirement would provide these banking organizations with additional flexibility for internal allocation of collateral" this additional flexibility is a double-edged sword and, just as such flexibility may be used for internal risk management purposes, that same flexibility will most certainly also be driven by short term profit motives so as to encourage excessive risk if initial margin is not required. Prophecy is not required to see where the repeal of the inter-affiliate initial margin provision will lead (even if it takes 5 or 10 years to get there). It only takes a few excessive risk takers to influence and drive the market and create the competitive pressures that will dictate that others follow suit and move to taking on more risk in order to generate greater return. The repeal of the initial margin rules for affiliates will allow market participants to utilize affiliates who take on too much un-margined risk while shifting that risk to their taxpayer supported affiliates. Without the guidance of the U.S. prudential regulators, namely yourselves,

prudence is likely to be disregarded in the name of short term profits; including risky and illusory short-term profits that will vanish once the consequences of excessive risk taking hits the system (sometimes a few years after the illusory profits have been distributed; leaving the nation's hardworking taxpayers to bear the loss). The proposal's reference to the fact that other jurisdictions do not consistently apply swap margin rules to inter-affiliate swaps as being a reason to eliminate the requirement, is already an example of competitive pressures that lead to the lowering of risk management standards. As some will undoubtedly use the flexibility provided by the repeal of the inter-affiliate initial margin provisions to profit by taking on more un-margined risk (rather than prudently managing risk), others will be forced by competitive pressures to follow their lead.

In addition, as mentioned in the rule "As more covered swap entities have come into scope, the amount of inter-affiliate initial margin collected by covered swap entities has increased. This has led the affected banking organizations to 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 to depositors and other creditors in the market." This is not a reason to repeal collateral requirements but, to the contrary, points out just how much is at stake and how significant the funding and liquidity needs will be in the event that entities excused from providing initial margin by the proposed rule ever need to fund the positions that the initial margin being repealed would have backed. When the affected banking organizations have "to borrow increasing amounts of cash in the debt markets to fund eligible collateral", this borrowing places a constraint on how much risk they can incur; the repeal of the initial margin removes this constraint without a commensurate reduction in the risk that may be incurred. In other words, the repeal of the inter-affiliate initial margin provisions does not reduce the risk that the affected banking organizations are permitted to incur but rather simply removes the initial margin backing that risk (leaving that risk unsecured). Or to put it yet another way, if the risk positions the affected banking organizations are taking with their affiliates are such that the affected banking organizations have "to 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 to depositors and other creditors in the market" then maybe they should not be incurring those kind of risks. Additionally, it is prudent for prudential regulators to make sure that the banking organizations "borrow increasing amounts of cash in the debt markets to fund eligible collateral" prior to a time of market trouble rather than wait until there is a market disturbance or distress situation and those same banks then have to fund those same positions in a difficult borrowing environment. As noted above, the risk exposure that would need to be funded is not being reduced; so it is preferable to have that risk covered upfront rather than waiting until a time of market stress to fund those positions.

While "the agencies note that certain affiliate transactions are subject to the requirements of sections 23A and 23B of the Federal Reserve Act as implemented by the Federal Reserve's Regulation W, as these requirements continue to apply to affiliate transactions with an insured depository institution" (84 FR 59976); rather than providing a reason to repeal the inter-affiliate initial margin provisions, the history and existence of Reg W speaks to the need to be extra vigilant when it comes to transactions between insured depository institutions and their affiliates. Reg W's existence is a recognition of the temptation and propensity of bank insiders, if left unchecked, to use taxpayer backed insured depository institutions to funnel money to related entities from which those insider's can themselves can benefit. While Reg W contains protections for certain types of affiliate transactions it does not cover the concerns and risks which the inter-affiliate initial margin provisions that would be repealed seek to address.

Finally, I cannot even begin to imagine the type of pressure you, as prudential regulators, must be under to repeal the well thought out and designed inter-affiliate initial margin provisions. That said, this is America and I believe it to be a country where a lone citizen can weigh in and make a difference; accordingly I felt it behooved me to try and do so. The repeal of the inter-affiliate initial margin provisions, if it is accomplished, opens the door to un-margined risk for which taxpayers are the ultimate backers; the legacy of each agency and its leaders may be impacted. It is my hope that all are on the right side of history.

As mentioned, this letter does not comment on any other aspects of the proposed rule (i.e. I have no comments on the portions of the proposed rule permitting swaps entered into prior to an applicable compliance date (legacy swaps) to retain their legacy status in the event that they are amended to replace a discontinued rate, clarifying the point in time at which trading documentation must be in

place, permitting legacy swaps to retain their legacy status in the event that they are amended due to certain types of amendments, and making technical changes to relocate the provision addressing certain types of amendments.) The only comments I have on the well thought out proposed rule are those above pertaining to the repeal of the inter-affiliate initial margin provisions.

Thank you for your time and consideration and for your guidance and stewardship of our nation's financial system.

Very truly yours,  
Elliot MacDonald