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May 17, 2012

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Dear Mr. Bernanke:

Last week, a major bank holding company directly supervised by the Federal Reserve Board announced a $2.0 billion loss on derivatives trades undertaken by its subsidiary bank for hedging purposes in a supposedly low-risk portfolio for the bank's own account. The bank's chairman has described the trades as "flawed, complex, poorly reviewed, poorly executed and poorly monitored" and said the loss may increase. The announcement triggered a major sell-off of the bank holding company's stock and the loss of billions of dollars in equity value.

This development is troubling for a number of reasons. Among other things, it raises serious questions concerning the competency of bank managers and banking regulators to supervise risks within large, complex banking organizations. The bank in question was subject to prudential supervision by dozens of on-site bank examiners. Neither they nor the bank's risk managers appear to have been aware of the activity that resulted in the $2.0 billion loss until it was too late. The occurrence will be reflected in banking history as a seminal failure of supervision and risk-management.

More fundamentally, this occurrence raises questions concerning the vast expansion of the federal safety net that has resulted from government policies since the financial crisis, the concentration of assets in the banking system, and the apparent intent of the Federal Reserve to discourage diversity in the financial system by eliminating money market funds as safe and efficient alternatives to banks.

The size of the bank's loss suggests that the portfolio that was being "hedged" was sizable, perhaps as much as $100 billion by some reports, which raises a question of where the bank got all of that cash and why that cash wasn't

deployed in the bank's business of making loans. The answer lies in the swelling of the federal safety net as a result of government policies. In particular, the size of the bank's loss undoubtedly relates to the amount of excess deposits it holds. The bank apparently could not find borrowers for its excess deposits. It was not satisfied with the 25 basis points it could earn by placing the deposits on reserve with the Federal Reserve, and sought to profit by engaging for its own account in trading and hedging activities.

Why did the bank have such a large amount of excess deposits on hand to invest for its own account? The reason is that the amount of government-insured deposits has ballooned since the financial crisis, nearly all of which has gone to large banks that have grown even bigger and more "too-big-to-fail" than before the crisis. The government has more than doubled the amount of FDIC deposit insurance, from $100,000 to $250,000.

But perhaps more significantly, the FDIC in 2008 extended *unlimited* deposit insurance to bank depositors with noninterest bearing checking accounts. The FDIC did this without any legal authority, ostensibly to stabilize banks during the chaos following Lehman Brothers' bankruptcy. In the Dodd-Frank Act, Congress gave the FDIC explicit authority to provide unlimited insurance for such accounts until December 31, 2012.

As a result of this unlimited deposit insurance, total insured bank deposits increased from $4.5 trillion in the second quarter of 2008 to $7.0 trillion at year-end 2011—a $2.5 trillion increase.[1] Of this $2.5 trillion increase, $1.4 trillion is in deposits in excess of $250,000, which are covered by unlimited insurance.[2] Of this $1.4 trillion, $1.07 trillion is concentrated in 19 banks with assets of over $100 billion, and $128 billion is concentrated in 18 banks with assets of $50-100 billion.[3] In other words, the 47 largest banks, all of which are deemed to be systemically significant under the Dodd-Frank Act (i.e., they have assets of $50 billion or more) are the primary beneficiaries of unlimited deposit insurance. Excess deposit insurance has resulted in excess deposits at banks for which there is no loan demand and which banks apparently are using for proprietary trading and hedging activities.

[1] See Federal Deposit Insurance Corporation, Quarterly Banking Profile, 2008, Vol. 2, No. 3, Table VII-A, compared with Quarterly Banking Profile, 2012, Vol. 6, No. 1, Table I-B.

[2] Federal Deposit Insurance Corporation, Quarterly Banking Profile, 2012, Vol. 6, No. 1, Table 1.

[3] *Id.*

The $2.0 billion derivatives loss has demonstrated that banks still are a significant source of risk in the financial system. Although the $2.0 billion loss we know about does not threaten the viability of the bank that incurred the loss, we don't yet know the total amount of the loss—in one week it reportedly grew by another $1.0 billion. It is not known how many other banks are pursuing a similar trading and hedging strategy and what their losses might be. Cumulative losses could pose a systemic threat to the banking system. Moreover, we do not yet know whether these activities might have a destabilizing or disruptive effect on the financial markets. Will the bank be able to repay depositors who want their money back when the unlimited deposit insurance expires?

A large portion of the excess deposits in the banking system has flowed to banks from money market funds ("MMFs"). MMFs provided a safe haven during the financial crisis but have lost approximately $1.4 trillion in assets since then, most of which has been attracted to banks because of the unlimited deposit insurance. Had this money stayed in MMFs, MMFs would have invested all of it in corporate debt, municipal securities, and U.S. government securities for the benefit of the economy. MMFs would not have engaged in risky trading or hedging activity. Unlike banks, MMFs are subject to a regulatory framework that does not allow such activity. MMFs would have earned a return (albeit small in today's low interest rate environment) on investments for their investors—which include pension funds, charitable foundations, other fiduciaries, treasurers, municipalities, and millions of individual savers and retirees—while providing a source of funding to corporations and municipalities to support economic growth.

Because of their simple structure, MMFs are safe and efficient financial intermediaries. They do not leverage their shareholders' equity to generate risky assets and they do not use money entrusted to them by their "depositors" to engage in risky trading or hedging practices. When they invest in tax-exempt municipal securities, their investors get the tax benefits. Their investments are limited by regulation to high-quality investments with minimal credit risk. They do not engage in off-balance sheet activities. They are managed by professional portfolio managers and registered investment advisers who have the status of fiduciaries under the law.

It thus is baffling why the Federal Reserve has launched a crusade to impose structural changes on MMFs that would effectively eliminate them from the financial system. Statements by yourself, other Board members and Federal Reserve Bank presidents in speeches, Congressional testimony, and comments to the media leave no doubt that the Board seeks to reduce money market funds as a source of short-term financing by eliminating the characteristics that make them

useful cash management tools or imposing inappropriate regulatory requirements on them.

The $2.0 billion derivatives trading fiasco demonstrates that the Board is engaged in a high stakes gamble. The bank had more cash than it could lend out and sought to earn a profit through risky trading and hedging activities, which even the Volcker Rule might allow. In contrast to MMFs—whose portfolios are fully transparent and appear on websites of fund companies and the SEC—the trading activities of banks are complex and hidden from public view (and apparently regulators) until a blowup of significant magnitude comes to light.

Shrinking MMFs to further concentrate financial assets in the banking system will only increase, not reduce, systemic risk. Moreover, it seems highly doubtful that the Board understands the operations and regulation of MMFs sufficiently to aspire to supervise them effectively. It is particularly unclear what "more stringent" prudential standards the Board could impose on MMFs that are not already imposed under regulations of the Securities and Exchange Commission, which is the independent agency to which Congress has assigned supervisory and enforcement responsibility for MMFs. The SEC has decades of regulatory experience with MMFs and dozens of staff who are expert in the operations of these useful entities, which have operated successfully for over 40 years with a safety record far superior to that of banks.

A number of lessons should be learned from the $2.0 billion derivatives loss debacle. One lesson is that any extension of unlimited deposit insurance beyond December 31, 2012 would be a mistake. Another lesson is that diversity in the financial system is healthy. For decades, MMFs have counterbalanced weaknesses in the banking system and, because of their risk-averse nature, exerted an element of market discipline within the financial system. By holding short-term assets outside the banking system, MMFs reduce the size of the federal safety net and exposure of taxpayers to instability at banks. The concentration of financial assets in the banking system exposes those assets to political pressures regarding the allocation of credit in the economy. For example, banks are subject to regulations—including capital requirements—that encouraged excessive credit allocation to the household sector and over-leveraging by American consumers. These regulations contributed to the housing bubble that fueled the recent financial crisis and regulatory arbitrage that resulted in undercapitalized risk-taking by banks.

The concentration of additional assets in the banking system would mean that more of the financial system would be subject to banking regulation and the mistakes of banking regulators. As commentators elsewhere have described,

regulatory action and inaction by U.S. banking regulators contributed in significant ways to the buildup of risks in the banking system prior to the crisis. A diversity of regulators, along with a diversity of institutions, may foster a healthier financial system in the long run.

I recently published two papers disputing assertions by yourself and others that MMFs are subject to runs and that the "unregulated shadow banking system" operating outside the regulated banking system exacerbated the financial crisis. I also have written to Eric Rosengren concerning statements he has made regarding the risks of MMFs. I have submitted these materials to the SEC for consideration in connection with its deliberations on MMFs and am enclosing them here with the hope that you will find them useful as you contemplate this matter further.

Respectfully,

Melanie L. Fein

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Enclosures

cc: Daniel K. Tarullo
Member, Board of Governors of the Federal Reserve System

Securities and Exchange Commission