November 10, 2015

The Honorable Timothy Massad
Chair
Commodity Futures Trading Commission
1155 21st St. NW
Washington, DC 20551

The Honorable Mary Jo White
Chair
Securities and Exchange Commission
100 F St. NE
Washington, DC 20549

Dear Chair Massad and Chair White:

The Dodd-Frank Act Wall Street Reform and Protection Act’s goals of reducing financial system and taxpayer risk posed by swaps trading have been sharply undercut in the last year.

In December 2014, Congress repealed key Dodd-Frank provisions limiting taxpayer-backed banks’ swaps holdings. Through a nearly year-long investigation, we have learned that this change will allow giant, Federal Deposit Insurance Corporation (FDIC)-insured banks to keep an estimated $10 trillion in risky swaps trades on their books. We have also learned that key regulators have yet to fully assess the economic and taxpayer risks of this Dodd-Frank rollback.

Recently, the problem was compounded when the Federal Reserve, Comptroller of the Currency (OCC), FDIC and other regulators backed down on critical rules that would have required banks to maintain adequate capital margins on swaps trades with their affiliates.

Your agencies are finalizing new rules on swaps trades and are in position to respond to these legal and regulatory rollbacks. We write today to urge that you act quickly to mitigate the risks posed by uncleared swap activities by imposing strong margin requirements for swaps between bank affiliates and other entities under your agencies’ authority. This letter provides more details about these findings and this request.
Our Investigation of the 2014 Repeal of Dodd-Frank “Swaps Pushout” Requirements

The original provisions of Section 716 of the Dodd-Frank Act prevented federally insured banks from putting taxpayer guarantees at risk by requiring them to “push out” the riskiest types of swaps transactions to non-federally insured subsidiaries.¹ The purpose of these provisions was to ensure that taxpayers were not on the hook for financial risks taken by the banks. These requirements were gutted by Section 630 of the 2015 Consolidated and Further Continuing Appropriations Act, inserted just prior to a vote on the Act and after intense lobbying from the financial industry.² In January of this year, we wrote to four banks asking for information on the risks that repeal of Section 716 created, but we received only limited information in response to our inquiries.³ We then wrote to the FDIC, Federal Reserve, OCC, and CFTC in July 2015, asking for clear and quantifiable information on how this partial repeal of Dodd-Frank would affect banks’ swaps activity and risks to taxpayers.⁴

The Repeal of Dodd-Frank Allows Banks to Continue Trading Trillions of Dollars of Risky Swaps Using Taxpayer-backed Funds

The information we have obtained from regulators provides the first estimates of the size of the loophole created by the Section 716 repeal, showing that it will allow federally insured banks to continue trading trillions of dollars of risky swaps using taxpayer-backed funds.

In its response to our letter, the FDIC described the impact of the 2014 changes to Dodd-Frank:

¹ Pub. L. 111-203, §716.
Had Section 716’s safe harbor not been amended earlier this year, an [insured depository institution] swaps dealer would have had to limit its non-hedging swap activity to ... swaps that reference rates, e.g., interest rate swaps, and swaps that reference assets permissible for investment by a national bank.\(^5\)

The FDIC stated that the swaps that banks will now be able to keep within their federally insured depository institution (IDI) rather than being forced to push out include “non-hedging swaps that reference, for example, equities and commodities other than bullion (e.g., gold and silver) as well as uncleared credit default swaps not entered into for hedging purposes.”\(^6\)

Regulators indicated that, because the original Section 716 was prospective in nature, requiring the push-out only of swaps trades entered into after July 2015, it “did not require the immediate push-out of all this activity.”\(^7\) The OCC indicated that it would be possible to “use call report historical information, however, to make a rough generalized estimate of the new swaps activity that banks have historically generated, and that may serve as an estimate of the annual volume of swaps they would have been prospectively required to push out.”\(^8\) FDIC and OCC provided similar estimates of the swaps trading value that would have been affected had 716 been implemented as enacted in Dodd-Frank.

The FDIC estimated that the fifteen banks currently registered as swap dealers with the CFTC and their subsidiaries hold up to $9.7 trillion worth of these types of derivatives, including roughly $6.1 trillion in credit derivatives, $1 trillion in commodity derivatives, and $2.6 trillion in equities derivatives.\(^9\) These swaps represent 4.4% of all outstanding derivative contract holdings at insured depository institutions registered as CFTC swaps dealers.\(^10\)

---

\(^5\) Letter from Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation to Senator Elizabeth Warren and Representative Elijah E. Cummings (September 14, 2015).

\(^6\) Id.


\(^8\) Id.

\(^9\) Letter from Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation to Senator Elizabeth Warren and Representative Elijah E. Cummings (September 14, 2015). These estimates represent an upper bound estimate of the amount that would have been pushed out, because Call Report data does not distinguish between non-hedging and hedging swaps activity. Section 716 prohibitions would have applied only to non-hedging swaps activity.

\(^10\) The values reported by the FDIC and other entities represent the notional value of outstanding derivatives contracts. The banks and other analysts have argued that other measures of value — such as mark-to-market value — may present a more accurate indication of potential risks, but did not provide an estimate of these values. See, e.g., Letter from John Collingwood, Bank of America, to Sen. Elizabeth Warren and Rep. Elijah E. Cummings (Feb. 26, 2015) (www.warren.senate.gov/files/documents/BofAResponse.pdf).
The OCC provided similar estimates, stating that:

we roughly estimate that notional derivatives for commodity, equity and credit derivatives increased by $6.7 trillion in 2012, $12.2 trillion in 2013, and $5.0 trillion in 2014. This growth represents 11.8 percent of the total $203.1 trillion of notionals outstanding. If historical behavior is representative of future behavior, these totals provide a range of estimates for the annual amount of notional derivatives that banks would have been prospectively required to push out.\textsuperscript{11}

In contrast to the trillions of dollars of swaps trades that would have been pushed out had Dodd-Frank not been weakened last year, the FDIC noted that under the new, weaker law, “we anticipate the amount of structured finance swaps that would be pushed out … would be relatively small.”\textsuperscript{12}

Financial Regulators Have Failed to Assess the Risks Created by the Section 716 Rollback

In response to our inquiry, the FDIC noted potential concerns about the Section 716 rollback, stating that “generally speaking, large volumes of derivative activity conducted by an IDI would be expected to increase its risk profile.”\textsuperscript{13} However, neither the FDIC nor any other prudential regulator was able to calculate the risks that will be posed by the fact that taxpayer-backed institutions will still be allowed to enter into trillions of dollars in risky swaps trades.

The Federal Reserve stated it “did not undertake an assessment of the effect of an amendment to Section 716 compared to the originally enacted section nor did we conduct an assessment of the impact of the amendment of section 716 on bank behavior in the swaps market, risks to the U.S. economy, or other matters.”\textsuperscript{14}

Similarly, the OCC wrote that “the OCC has not made any specific assessments regarding the impact of the partial repeal of the swaps push-out rule on the risk of taxpayer-funded bailouts … the OCC has not conducted any specific assessments regarding the impact of the partial repeal on bank behavior in the swaps markets … [and] the OCC has not made any assessments regarding the risks to the U.S. economy resulting from the partial repeal of Section 716.”\textsuperscript{15}


\textsuperscript{12} Letter from Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation to Senator Elizabeth Warren and Representative Elijah E. Cummings (September 14, 2015).

\textsuperscript{13} Id.

\textsuperscript{14} Letter from the Honorable Janet Yellen, Chair, Federal Reserve, to Senator Elizabeth Warren and Representative Elijah E. Cummings (September 9, 2015).

The Honorable Timothy Massad  
The Honorable Mary Jo White  
Page 5

The failure to assess the impact on banks and the economy of the repeal of Section 716 raises critical questions about whether federal policymakers are sufficiently attentive to the risk posed by nearly $10 trillion of risky swaps now primarily held – and allowed to be traded and held on an ongoing basis – by a handful of the country’s largest, FDIC-insured banks.

The response from the FDIC also raises questions about claims by banks that the rollback was necessary to maintain their competitive positions in the marketplace. Data provided by the FDIC show that two bank holding companies – with the second and fifth highest volumes of credit derivatives activity – already conduct the vast majority of their swaps activity in subsidiaries that are not federally insured. These bank holding companies are competitive without federal assistance. The FDIC indicated that this example “strongly suggest[s] that credit derivatives activity conducted out of [insured depository institutions] swap dealers at the other 11 bank holding companies that would have been subject to the [Section 716] prohibition can successfully be pushed out to a non-IDI affiliate or financial subsidiary.”

New “Margin Rules” Finalized by the Financial Regulators Are Inadequate and Fail to Address New Risks Posed by the Section 716 Rollback

Although the repeal of major portions of Section 716 created significant new risks, other federal laws are designed to mitigate risks to taxpayers and the American economy stemming from risky swaps activity. One of these provisions is the Dodd-Frank requirement that bank prudential regulators (the Federal Reserve, FDIC, OCC, Federal Housing Administration, and the Farm Credit Administration) jointly craft initial and variation margin requirements on all non-centrally cleared swaps. The proposed Margin and Capital Requirements for Covered Swap Entities rule was released in September 2014 and, in its proposed form, required both banks and their affiliates to post margins on all inter-affiliate swaps, a critical protection insulating federally insured institutions from risky behavior on the part of their affiliates.

The banking industry fought hard against this provision, and when these rules were finalized last month, they had won a “lucrative concession” in the rules.

---

16 Letter from Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation to Senator Elizabeth Warren and Representative Elijah E. Cummings (September 14, 2015).
Where the initial draft of the rule required that both banks and their affiliates retain initial margin for inter-affiliate swaps trades, the final rule stripped away this two-way initial margin posting requirement. This “means the U.S. banking divisions of the biggest swaps dealers ... wouldn’t have to pledge collateral to offset risks from non-cleared swaps with their overseas affiliates, such as a U.K. brokerage,” which may be “less regulated and capitalized.”

This action is good for Wall Street because it cuts their costs by billions of dollars. But it increases risks for taxpayers on top of those already posed by the repeal of Section 716.

CFTC and SEC Should Impose Strong Regulations to Protect Taxpayers and the Financial System

While the Dodd-Frank rollback and the weak margin requirements imposed by prudential regulators have created new risks for taxpayers and the financial system, your agencies are in position to mitigate these risks. In addition to requiring the prudential regulators to issue joint margin rules governing swaps entered into by banks, Congress required the Securities and Exchange Commission (SEC) and CFTC to issue rules applicable to swaps dealers and other swap participants, governing uncleared swaps.

In November 2012, SEC proposed its rule for Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security Based Swap Participants and Capital Requirements for Broker-Dealers. In October 2014, the CFTC released a proposed rule on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants.

These rules will be structured to work in conjunction with the rules approved last month by the prudential regulators to reduce risks from swaps trading. As a result, they provide your agencies with an opportunity to fill the wide gaps created by the failure of prudential regulators to require two-way margins on swaps trades and to hold bank affiliates to strict margin requirements that they escaped under the earlier rulemaking.

---


21 Id.


Last month, FDIC Vice Chairman Thomas Hoenig criticized the rules finalized by FDIC, but he was also clear about the key roles played by your agencies. He said, “the system overall would have been best served if banks posted as well as collected margin with their affiliates...other agencies with jurisdiction over nonbank affiliates could require those firms to collect margins as they finalize their rules on this matter.”

As your agencies finalize these rules, we urge you to act to protect the financial system and protect taxpayer interests. Specifically, we ask that the final rules you put in place mitigate the risks posed by uncleared swap activities by imposing strong margin requirements for swaps between bank affiliates and other entities under your agencies’ authority.

If you have any questions about this letter, please contact Todd Phillips at (202) 225-4741 with Ranking Member Cummings or Brian Cohen with Senator Warren at (202) 224-4543. Thank you for your cooperation with this matter.

Sincerely,

Elijah E. Cummings
Ranking Member
Committee on Oversight and Government Reform

Elizabeth Warren
Ranking Member
Subcommittee on Economic Policy

---