American Bankers Association
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Mr. Brian Smith
Director, Office of Capital Markets
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Via electronic mail

RE: U.S. Treasury's Report to the President on A Financial System That Creates Economic Opportunities – Capital Markets

Dear Mr. Smith,

The American Bankers Association (ABA)[1] appreciates the opportunity to meet with you and your colleagues recently to discuss financial market issues and reforms that could improve their functioning so as to promote economic growth. . Please find below a summary of the points that we made during our meeting.

The surcharge on Global Systemically Important Banks (G-SIBs) should not be made procyclical under the Comprehensive Capital Adequacy Review (CCAR)

In July 2015, the Federal Reserve Board finalized its capital surcharge rule for the eight U.S. U.S. G-SIBs. This G-SIB surcharge functions as a countercyclical buffer, added to applicable capital requirements to absorb losses during stressed economic periods without eroding basic bank capital standards. There have been some suggestion of changes that would make this stress testing procyclical, reducing the ability of supervisors and bank managers to respond at the onset of actual financial and economic stresses with the resources that banks have at hand. Most troublesome in this regard is the possibility of including the heightened capital requirements for banks identified as globally systemically important banks into the CCAR.

Although the details of such ideas have not yet been disclosed, it is clear that its inclusion would be a departure from the current method of evaluating banks. When the economy turns south, our nation has traditionally looked to banks as economic shock absorbers, able to continue providing financial services longer than might other financial firms, positioned to work with borrowers and customers to make appropriate financial adjustments. That is the conceptual, countercyclical purpose of capital buffers, allowing banks to perform this traditional role unless and until financial or economic conditions force a retrenchment.

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits and extend more than $9 trillion in loans.

The GSIB surcharge is part of that buffer system, not part of the minimum capital requirement. Rather, it is an element of the capital conservation buffer that is "designed to absorb losses in stressful periods…" As the agencies have recognized, a bank "must be able to use some of its capital conservation buffer"[2] without breaching minimum capital standards. Including part of the capital conservation buffer into the CCAR stress tests as part of a minimum capital standard rather than operate as a genuine buffer would compel banks to retrench much earlier in an economic downturn, reinforcing and exacerbating the downturn, contrary to the basic notion that the buffers should be used during times of stress to absorb adjustment costs before reaching minimum capital standards.

The Liquidity Coverage Ratio (LCR) requirement for banks promotes the hoarding of High Quality Liquid Assets (HQLA) and has the potential to constrain bilateral swaps activity; the definition of HQLA should be expanded

The LCR, (as embodied in U.S. regulation), requires banks to hold HQLA equal to regulatorily posited funding outflows in a period of stress. Unfortunately, the LCR's restrictive limitation on the types of assets that qualify as Level 1 liquid assets are also essentially the same asset types that are considered to be eligible collateral under rules on margin for uncleared swaps This, together with other regulations that generate demand for these assets (e.g. Basel III capital rules, net asset value standards for money market mutual funds, added to the reliance of the market for repurchase agreements on HQLA assets) has the potential to constrain bilateral swaps activity as banks will cache these assets to meet their LCR requirement, reducing their availability for use as eligible collateral in uncleared swaps transactions.

The CFTC's Swap Dealer registration threshold should better reflect systemic risk

The CFTC should promptly definitively set the swap dealer registration *de minimis* threshold at $8 billion aggregate gross notional amount (measured over the prior 12-month period)

The Commodity Exchange Act (CEA) defines the term "swap dealer" and authorizes the CFTC to exempt entities that engage in a *de minimis* quantity of swap dealing in connection with or on behalf of customers.[3] The CFTC fixed the amount at $3 billion gross notional but subjected that amount to a "phase-in" level of $8 billion gross notional.[4] The "phase-in" termination date is December 31, 2018.[5] However, if the CFTC does not definitively set the *de minimis* threshold at $8 billion before January 1, 2018, entities will have to start counting the gross notional amounts of their swaps activity at the first of the year because of the 12-month "look back" requirement of the CFTC.

[2] 78 Fed. Reg. 62,018, 62,041 (Oct. 11, 2013).
[3] 7 U.S.C. § 1a(49)(D)
[4] CFTC Regulation 1.3(ggg)(4); 17 C.F.R. § 1.3(ggg)(4). The fact that the CFTC was willing to set a preliminary threshold at $8 billion suggests that entities below this level do not pose systemic risk issues. Congress agrees with this assessment as evidenced by its direction in December 2015 to the CFTC to establish the *de minimis* threshold at $8 billion or greater within 60 days of enactment of the Appropriations Act, i.e., by February 16, 2016. Congressional Directives, Division A – Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act of 2016, p. 32, available at *http://docs.house.gov/meetings/RU/RU00/20151216/104298/HMTG-114-RU00-20151216-SD002.pdf*
[5] "Order Establishing De Minimis Threshold Phase-In Termination Date", 81 Fed. Reg. 71605

Prompt action by the CFTC to definitively set the threshold at $8 billion well before January 1, 2018 would foster economic activity for the following reasons.[6]

Definitively setting the threshold at $8 billion would ensure that many customers, who rely upon services from smaller banks, will be able to have their risk management needs continue to be met as they currently are. Failure to maintain the $8 billion threshold would likely limit the ability of many commercial end users to access the swaps market to manage their risk in a responsible manner and would effectively counter the broad based regulatory relief that was intended to be afforded to end-users in the Dodd-Frank Act. This is because such commercial end users enter into swaps with commercial banks in conjunction with their obtaining of credit (usually in the form of loans or lines of credit) from such banks. A lowering of the threshold will cause such commercial banks not to enter into swaps with borrowers, which would be a perverse outcome from a risk management perspective.

Lowering the threshold would serve no policy objective. As the CFTC staff's Swap Dealer De Minimis Exception Final Report pointed out, lowering the threshold to $3 billion would pull in approximately 84 additional entities trading in interest rate swaps and credit default swaps but will only cover 1% of additional swap activity. The costs involved in 84 additional entities having to register as swap dealers and establishing policies, procedures and systems to ensure compliance with the CFTC's swap dealer rules – and, as we have pointed out, more likely push these banks out of these markets - would achieve no benefits from the perspective of systemic risk management given their tiny share of the overall swaps markets.

Commercial banks enter into non-financial commodity swaps mostly with customers that are engaged in energy and agricultural production and distribution (e.g., oil and gas drilling, cattle feeding and corn growing or storing). These customers are typically smaller, non-investment grade firms with secured loan agreements which benefit from executing hedging swaps with their lenders. By managing exposure to commodity price fluctuations, clients increase their borrowing capacity. From the commercial bank's perspective, the ability to provide these swap hedges to their borrower clients stabilizes and protects the value of the commodity loan collateral, allowing their customers to expand their business because the bank will be able to lend more to these clients than it would in the absence of the risk management provided by the non-financial swap hedges.

If the CFTC fails to maintain or raise the *de minimis* threshold, banks will likely have to curtail their hedging services to customers to avoid the costs of becoming a swap dealer. This reduces risk mitigation services to companies that need it. These clients will (a) have less access to capital as a function of the negative impact of exposure to commodity price fluctuations, and (b) likely have higher hedging costs through less competition. While they could execute hedges with counterparties that were not lenders, the need to cash-collateralize the hedges counteracts any liquidity benefit. If borrowers cannot, or choose not to, hedge their risks because other hedge providers are unwilling to transact with them or the hedging products are too expensive, the risk of loan losses to banks increases. Smaller energy and agricultural producers will face higher

[6] ABA's letter of January 19, 2016 to the CFTC commenting on its initial *de miminis* study lays out these reasons in more detail. *See* *https://www.aba.com/Advocacy/commentletters/Documents/ABA%20ABASA%20Joint%20Comment%20Letter%20to%20CFTC%20regarding%20SD%20De%20Minimis%20Exception%20Preliminary%20Report.pdf*

market risk and reduced access to credit, perhaps exacerbating an already struggling industry sector.

The notional threshold impacts non-financial swaps differently from financial swaps. Risk mitigating commodity swaps are not entered into at the inception of the loan, and are of a shorter tenor and a smaller average notional size as compared to other asset classes. With risk mitigating commodity swaps, customer financial risk management needs drive the timing and number of transactions. As energy customers drill or acquire new wells, they will enter into additional risk mitigating swaps. As they pare back, their activity lessens. The level and frequency of trading is tied to collateral value and covenants.

Measuring notional values for non-financial swaps differs from that for financial swaps. For non-financial swaps, notional is a function of both volume of the underlying and price of the underlying exposure. In periods like 2015 with low commodity prices and scaled back production, the average notional size is lower than for interest rate swaps. Within a twelve month period, this could reverse quickly. With no increase in volume, but an increase in commodity prices, asset classes with previously low average notional swap size could show larger notional production. Similarly, holding commodity prices steady while production increases could raise average notional in a short period of time.

The CFTC's implementation of the Insured Depository Institution (IDI) exclusion is unduly restrictive and not consistent with the statutory language

The definition of swap dealer in the CEA[7] also contains a proviso which is known as the IDI exclusion. It states that "in no event shall an insured depository institution be considered to be a swap dealer to the extent that it offers to enter into a swap with a customer *in connection with originating a loan*[8] with that customer." Unfortunately, in its regulatory implementation of the statutory exclusion[9], the CFTC has created an excessively rigid framework that fails to recognize how borrowing customers of commercial banks use swaps by imposing various restrictions that are not supported by the plain statutory language and limit the ability of banks to serve customers that execute loan-level hedges.

ABA has shared with the CFTC typical borrower hedging practices that should be recognized in a more flexible approach to the IDI exclusion[10] certain of which we highlight below.

The CFTC's implementation of the IDI exclusion provides that in order to qualify for the exclusion, an IDI must enter into a swap no later than either 180 days after the date of execution of the loan agreement or 180 days after any transfer of principal to the customer by the IDI pursuant to the loan[11]. This 180-day count convention limits the ability of commercial end users to manage risk in a proactive manner. It has resulted in a reduction of hedging options for end users as banks limit activity that counts toward the *de minimis* threshold, a concern that would be

[7] 7 U.S.C. § 1a(49)(A)
[8] Emphasis ours
[9] *See* CFTC Regulation 1.3(ggg)(5); 17 C.F.R. § 1.3(ggg)(5)
[10] ABA comment letter to the CFTC of November 3, 2011 in response to a request for comments regarding the definition of 'swap dealer'. *See* *https://www.aba.com/Advocacy/commentletters/Documents/Swap-Dealer-11032011.pdf*
[11] *See* CFTC Regulation 1.3(ggg)(5)(i)(A); 17 C.F.R. § 1.3(ggg)(5)(i)(A)

exacerbated if the *de minimis* threshold were lowered. Some borrowers might, for example, opt to observe market conditions for an extended period of time before entering into a hedging transaction. As an illustration, if a bank underwrites a ten year commercial real estate loan to a developer and the developer hedges at the origination of the loan, this swap qualifies for the IDI exclusion. If the same developer opts instead not to hedge his liability for 180 days and then hedge the remaining 9.5 years of the loan, this swap will not qualify for the IDI exclusion and would be considered "dealing" activity by the bank. Hedges can be employed to manage cash flows that ultimately are used to make payments on the outstanding portion of the loan and should not be restricted by timing of the draw or closing of a loan. Therefore, rather than apply an arbitrary 180 day limitation, which is not determinative of whether a swap is "in connection with an originating loan," the conditions for the IDI exclusion should focus on the risks the customer and bank are seeking to mitigate throughout the term of a loan. As long as the terms and structure match the remaining tenor of the underlying borrowing transaction, the hedging swap should qualify for the IDI exclusion.

In addition, the CFTC regulation's minimum commitment percentage that requires an IDI be responsible for at least 10% of a syndicated loan to exclude the swap from its calculation[12] should be eliminated as it serves no policy objective. Eliminating the 10% requirement will increase competition in the markets furthering a goal of the *de minimis* exception.

Bank Swap Dealers should not be required to collect initial margin from affiliates and more time should be allowed for swap counterparties to come into compliance with un-cleared margin rules

The Prudential Regulators[13] should remove the requirement for a covered swap entity to collect initial margin (IM) from its affiliates for swap transactions with affiliates (inter-affiliate trades) in their rules for margin for un-cleared swaps. Such action will be consistent with the CFTC's rules for margin for un-cleared swaps.

Inter-affiliate swaps are necessary for banking organizations to maintain a centralized risk management function.[14] Inter-affiliate trades do not increase the amount of risk being taken by a firm. Rather, they allow the firm to manage risk more effectively and in compliance with relevant regulations. Inter-affiliate transactions enable customers to recognize the netting benefits of engaging in transactions with a single entity of their choice. Inter-affiliate swaps permit a banking organization to match offsetting risk exposures existing within the group before hedging the net risk with third parties and central counterparty clearing houses (CCPs). Because the risk is netted and consolidated, these risk-transfer trades allow the firm to operate with less counterparty and operational risk than it would if it faced multiple counterparties through multiple affiliates. Inter-affiliate swaps also permit a banking organization to use its most expert trading and risk management personnel to manage any residual directional market risks. In these

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[12] *See* CFTC Regulation 1.3(ggg)(5)(i)(D)(2); 17 C.F.R. § 1.3(ggg)(5)(i)(D)(2)

[13] The Prudential Regulators are the Office of the Comptroller of Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

[14] ABA describes in more detail the beneficial and necessary uses of inter-affiliate swaps in its June 1, 2015 comment letter to the Prudential Regulators providing supplemental information regarding proposed initial margin requirements. *See* *https://www.aba.com/Advocacy/commentletters/Documents/6-1-15JointTradesLetterreUnclearedSwapsMargin.pdf*

circumstances, inter-affiliate swaps allow banking organizations to meet client demand and funding needs while appropriately allocating the resulting risks to the affiliate with the personnel, infrastructure, and expertise to manage them centrally and effectively.

Inter-affiliate initial margin does not facilitate a more orderly or successful single-point-of-entry ("SPOE") resolution strategy, which is particularly noteworthy given that SPOE is likely to be U.S. financial regulators' preferred approach to resolution of large, complex U.S. banking organizations under either a Title I bankruptcy or a Title II Orderly Liquidation Authority resolution. SPOE resolution contemplates the failure of the parent holding company coupled with the continued operation and solvency of all material subsidiaries, and thus does not contemplate the immediate close out of internal risk management trades between such subsidiaries. Therefore, two-way inter-affiliate initial margin between surviving affiliates would likely be largely irrelevant in an SPOE resolution scenario. In this regard, the viability and efficacy of an SPOE resolution regime is in no way dependent on a requirement for two-way inter-affiliate initial margin.

The CFTC should revise its overbroad interpretation of the overseas applicability of U.S. swaps rules that disadvantage overseas branches of U.S. banks

U.S. banks have long operated in other jurisdictions through branches as well as subsidiaries. The choice has traditionally depended on an assessment of the customer needs the bank is seeking to address, with consideration to the laws of the specific jurisdiction as to corporate form and permissible activities. The CFTC is unfamiliar with this form of operation, and, in implementing a new swaps regulatory framework, has adopted certain overbroad extraterritorial interpretations of its new rules that unnecessarily disadvantage operation overseas through branches.

A particular concern is the CFTC's interpretation of its rule establishing registration requirements for swap execution facilities (SEFs). Specifically, the CFTC interprets text in footnote 88 of the 108 page preamble to its final rule to mean that as long as one counterparty to a swap is a U.S. person, the swap has to be traded on a registered SEF, irrespective of where the swap transaction takes place. This disadvantages the foreign branches of U.S. bank swap dealers that are transacting with their U.S. and non-U.S. customers solely overseas. Non-U.S. persons in the location of the foreign branch refuse to trade with the branch because they do not want the U.S. swaps regime to apply to them. Furthermore, foreign swaps trading facilities do not allow the foreign branches of U.S. bank swap dealers to trade on the platforms because they do not wish to register as swap dealers.

We believe that, like swap dealer subsidiaries of U.S. bank holding companies, foreign branches of U.S. bank swap dealers should be permitted to comply with the regulations of the jurisdiction in which they are located (i.e., substituted compliance). This will allow U.S. swap dealers to compete with the swap dealers that are located in the same jurisdiction.

Foreign branches of U.S. bank swap dealers and guaranteed affiliates (typically subsidiaries) of U.S. persons who have to register as swap dealers are subject to both the CFTC's swaps regulatory regime and the regime of the jurisdiction in which they operate. While the CFTC has made comparability determinations with respect to six non-U.S. jurisdictions, they have been piecemeal at best and do not comprehensively defer to the foreign jurisdictions regulatory scheme insofar as foreign branches and registered foreign guaranteed affiliates are concerned.

The CFTC should exempt foreign branches of U.S. bank swap dealers and registered foreign guaranteed affiliates from complying with the CFTC regulatory regime and instead allow them to comply with the swaps regime in the jurisdictions in which they operate (i.e., substituted compliance).

We thank you for the consideration of our submission. Please do not hesitate to contact me at 202-663-5037 or anandar@aba.com if you have any questions.

Sincerely,

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