Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Farm Credit Administration
Federal Housing Finance Agency

September 7, 2011

Honorable Darrell Issa
Chairman
Committee on Oversight and Government Reform
United States House of Representatives
Washington D.C. 20515

Dear Chairman Issa:

Thank you for your letter of July 22, 2011 regarding the proposed rule, Margin and Capital Requirements for Covered Swap Entities.[1] The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Farm Credit Administration (FCA), and the Federal Housing Finance Agency (FHFA) (collectively the prudential regulators) jointly invited public comment on the proposed rule in April 2011 in accordance with requirements of sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). The comment period for the proposed rule closed on July 11, 2011. The prudential regulators received comments from a variety of commenters including nonfinancial (commercial) end users, banks that act as swap dealers, other entities regulated by the prudential regulators, trade organizations whose members have an interest in the rule, and other members of Congress.

As you noted in your letter, the prudential regulators face a number of difficult issues in crafting these rules required by the Dodd-Frank Act. We recognize the importance of the issues you raise, including the appropriate margin requirements for commercial end users, the liquidity impact of the margin rules, the types of collateral that can be posted as margin, how margin should be calculated, and the overall effect of the rules on swap market participants and the economy in general.

The prudential regulators asked many questions about these issues as part of the request for comment on the proposed rule in order to understand the potential effects of the proposal and to solicit views on the best way to address the risks and goals that motivated the provisions in the Dodd-Frank Act. We are currently analyzing the comments we have received, including the issues raised in your letter. In developing a final rule, we will carefully consider your comments and will strive to implement the statutory requirements in a manner that appropriately balances the costs and burdens to market participants with the statute's goals of reduced risk to the

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[1] Margin and Capital Requirements for Covered Swap Entities, Proposed Rule, 76 Fed. Reg. 27564 (May 11, 2011).

financial system and improved safety and soundness of swap dealers. [2] We also would welcome the opportunity for our respective staffs to meet with your staff to discuss the underlying issues and your questions regarding the proposed rule. As you suggested, the prudential regulators have joined together in this response.

Supervisory Authority [Questions 4-5][3]

In general, apart from the requirements of Title VII of the Dodd-Frank Act, the prudential regulators have broad and flexible supervisory authority, including informal and formal enforcement actions when necessary, to ensure that the entities under their supervision operate in a safe and sound manner, including when dealing with nonfinancial end users.[4] This authority covers all forms of credit activities. Similar to an extension of credit, a swap transaction exposes both sides to credit risk – the risk that one of the counterparties will not be able to make future payments due under the terms of the swap transaction. Prudential regulators currently require entities under their supervision to manage the credit risk of the swaps aspect of their counterparty relationships, just as those entities are required to manage the risks of other credit relationships, and to manage the combined credit risks of each customer or counterparty on an aggregate basis.

That credit risk management includes steps such as performing independent credit underwriting of new customers or counterparties to set a combined credit exposure limit for the particular customer or counterparty, measuring the credit exposure with appropriate metrics, monitoring the customer's or counterparty's financial condition and creditworthiness on an ongoing basis, and reporting all credit exposures with each customer or counterparty to management on an aggregate basis in a single report. The prudential regulators have specified the manner in which the financial institutions they regulate should prudently manage the credit risk and other risks related to derivatives.[5]

Prudentially regulated banks that act as swap dealers set internal (house) credit limits for each obligor based upon their view of risk. Generally, swap dealers are large financial institutions, and the house limit for any particular end user is considerably smaller than the legal lending limit and does not present a concentration of credit risk that would raise safety and soundness concerns. In addition, credit exposure from derivatives activities is generally a small part of aggregate credit exposure for the vast majority of nonfinancial end users. As a result,

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[2] For simplicity in this letter, the term "swap dealers" serves as a general reference to all entities that would be subject to the proposed rule. The proposed rule uses the term "covered swap entity" to refer to entities that are required to collect initial margin and variation margin. "Covered swap entity" is defined as an entity subject to each prudential regulator's jurisdiction that meets the definition of "swap dealer" or "major swap participant" as defined in the Commodity Exchange Act and Commodity Futures Trading Commission implementing regulations or of "security-based swap dealer" or "major security-based swap participant" as defined in the Securities Exchange Act of 1934 and Securities and Exchange Commission implementing regulations.

[3] Questions 1 through 3 are directed to the Commodity Futures Trading Commission and thus do not call for a response by the prudential regulators.

[4] The entities subject to supervision by the FHFA do not transact with nonfinancial end users and therefore this discussion of supervisory authority does not apply to FHFA.

[5] A list of the prudential regulators' guidance related to credit risk management is attached along with their web links.

larger exposures, such as direct loans and commitments to lend, would drive aggregate exposure limits, not derivatives exposures. In light of these factors, intervention by regulators is unlikely with respect to swap transactions with individual nonfinancial end users, including in the case of a swap dealer in deteriorating financial condition.

Your letter raises an issue that was not specifically addressed in the prudential regulators' notice of proposed rulemaking: whether a financial institution's decision to reduce its credit exposures, including exposures on swaps, in times of financial stress can cause difficulties for the broader financial system. Your letter refers to supervisory authority as a possible cause. Supervisors take great care to balance safety and soundness with the need to foster credit availability for creditworthy borrowers. However, it is quite likely that a financial institution would choose on its own to cut back on credit exposure when it is facing a challenging financial environment. The issue you raise is related to the Dodd-Frank Act's "macroprudential" approach to supervision and regulation, which considers the health of the financial system as a whole.[6] We will carefully consider your comment and the possible macroprudential consequences of credit exposure thresholds as we work to develop a final rule.

Calculation of Initial Margin [Questions 6-7]

Your letter points out that, when a counterparty default occurs, a swap dealer will re-hedge its market risk position based on its broader portfolio exposure at the time. Time to re-hedge is one component of the time horizon that is relevant for the calibration of initial margin.

The prudential regulators, in proposing the minimum characteristics of an initial margin model eligible for regulatory approval, included a number of standards that were intended to ensure that a non-cleared swap does not pose a greater risk than a cleared swap, consistent with the statutory mandate. In light of that mandate and other factors discussed in the preamble of the proposed rule, such as stress calibration and benchmarking, the prudential regulators requested comment on a 10-day time horizon for the calculation of initial margin. The prudential regulators based the proposed 10-day time horizon on a variety of factors that were specific to the non-cleared OTC derivatives market. The ability of the swap dealer in the event of counterparty default to price the contracts, to liquidate collateral outside of bankruptcy or receivership by the FDIC, FCA, or FHFA, and most importantly to re-hedge on a portfolio basis, were key considerations in proposing the 10-day time horizon.

The prudential regulators received numerous comments on the appropriateness of the proposed time horizon and are in the process of analyzing those comments. We will carefully review your comment, as well as other comments we have received, before we issue a final rule.

Impact of Margin Requirements on Nonfinancial End Users [Questions 8-12]

Your letter asks about the consequences for nonfinancial end users of the proposed margin requirements. The prudential regulators' proposal follows the statutory framework and proposes a risk-based approach to imposing margin requirements for transactions with

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[6] See, for example, Chairman Bernanke's speech to the 47th Annual Conference on Bank Structure and Competition, Chicago, Illinois, May 5, 2011.

nonfinancial end users. Nonfinancial end users appear to pose minimal risks to the safety and soundness of swap dealers and to U.S. financial stability when they hedge commercial risks with derivatives and the related unsecured exposure remains below an appropriate credit exposure threshold. Accordingly, the proposed rule does not specify a minimum margin requirement for transactions with nonfinancial end users. Rather, the proposed rule, consistent with long-standing supervisory guidance discussed above, would permit a swap dealer to adopt, where appropriate, its own thresholds below which the swap dealer is not required to collect margin from counterparties that are nonfinancial end users. Such thresholds would be set forth in a credit support agreement and approved and monitored by the swap dealer as part of its own credit approval process.

As noted in the proposal, this approach is consistent with current market practices with respect to nonfinancial end users, in which swap dealers view the question of whether, and to what extent, to require margin from their counterparties as a credit decision. Accordingly, the prudential regulators would expect that the direct costs and benefits of hedging with non-cleared derivatives by nonfinancial end users, including with respect to opportunity costs and earnings volatility, would remain unchanged relative to current market practices under the terms of the proposed rule.

In issuing the proposal, the prudential regulators requested comment on a variety of issues related to the effect of the proposed margin requirements on nonfinancial end users, including whether alternative approaches – such as an exemption similar to the mandatory clearing exemption – are preferable. We have received a variety of comments from members of the public, including commercial firms that use swaps to hedge their risk. The prudential regulators will carefully consider your comment and all other comments as we evaluate the proposal in light of comments received and formulate a final rule, as required by statute. Additionally, we will consider the case of Metallgesellschaft AG inasmuch as your letter indicates that the case may be relevant to the proposed rule's impact.

Eligible Collateral [Questions 13-14]

Your letter asks about the proposed rule's set of eligible collateral. The proposed rule identified a limited set of securities as eligible non-cash collateral for the initial and variation margin requirements, consistent with the statutory requirement in sections 731 and 764 of the Dodd-Frank Act that the rule permit non-cash collateral while preserving the "financial integrity of markets trading swaps" and the "stability of the United States financial system."

As noted in the proposal, non-cash collateral can be employed consistent with market integrity and financial stability when an appropriate haircut can be established to reflect its likely decrease in value during times of stress. Accordingly, the prudential regulators requested that commenters respond to several questions about possible expansions of the set of eligible collateral, including how to determine an appropriate haircut.

The prudential regulators do not seek to increase demand for Treasury and Agency debt. As we discussed in the preamble to the proposed rule, Treasury and Agency debt possess certain characteristics that are crucial to the ability to serve as effective margin collateral – namely that they retain their liquidity and relatively stable value in times of financial crisis, when counterparties are most likely to default. During the financial crisis of 2008, for example, collateral markets witnessed a flight to quality that resulted in the devaluing of many illiquid forms of collateral and an increase in demand for more liquid and stable forms, such as cash and Treasuries. The stability and liquidity of cash and Treasuries have made them reliable collateral for market participants and their use will, during a liquidity crisis, reduce the effects of the uncertain valuation and liquidity of many other forms of collateral.

In addition to your comment on this issue, the prudential regulators have received a variety of comments from firms that use swaps to hedge their risk, suggesting ways in which the prudential regulators can and should recognize as eligible collateral (i) the pledge of physical assets or commodities with "right way risk" or (ii) a broader range of securities. The prudential regulators will carefully consider these and all other comments as we evaluate the proposal in light of comments received and formulate a final rule, as required by statute.

The prudential regulators also would note that collateral posted by nonfinancial end users for exposures below the credit exposure threshold that is determined by the swap dealer is not limited to the set of eligible collateral in the proposed rule, because the proposed rule only applies to exposures above the credit exposure limit set by the swap dealer. Under the proposed rule, a swap dealer would be free to continue to accept whatever collateral it currently accepts from nonfinancial end users, including liens on physical assets that may generate "right way risk," in determining how high that internal threshold should be set, consistent with the swap dealer's credit underwriting expertise. The prudential regulators will continue to evaluate the proposed rule and will carefully consider all comments received as we proceed to a final rule.

Economic Impact of the Proposed Margin Requirements [Questions 15-19]

Your letter asks about the impact of the proposed margin requirements. As discussed in the preamble to the proposed rule, the proposed rule does set out margin requirements that represent a significant change from current industry practice for transactions between covered swap entities, for which the proposal would require significant increases in aggregate margin collateral. The proposed margin requirements would not, however, represent significant increases in margin collateral for nonfinancial end users.

The prudential regulators' staff working group on the proposed rule gathered data and attempted to quantify the increase in margin that would result from the proposal. However, at the conclusion of those efforts, the staff working group determined that the factors at issue in the proposed rule made reliable quantification of the margin increase exceptionally difficult at the proposal stage. As discussed in the preamble to the proposed rule, wide-ranging and as yet undetermined changes taking place in the derivatives market made such assessment particularly difficult, including (i) which entities will be defined as covered swap entities; (ii) the extent to which existing derivatives will be rolled over or renewed once the new, more costly margin rules are in effect; and (iii) the extent to which derivatives currently traded over-the-counter will be moved to central clearing. There are no reliable estimates for these key factors.

Accordingly, instead of basing the proposal on a quantitative analysis premised on a set of stated assumptions, the prudential regulators included a discussion of the above issues and an extensive request for comment on quantitative impact issues in the preamble to the proposed rule. The prudential regulators did not discuss issues or include specific questions pertaining to the demand for Treasury and Agency securities, because the proposed rule was in no way premised on this factor. As the prudential regulators proceed to a final rule, we will review the public comments and continue to evaluate the potential quantitative impact of the margin requirements.

Provision of Documents

Each of the prudential regulators will respond separately to provide key documents related to the proposed rule phase of the process. Please feel free to contact any of the prudential regulators with further questions regarding this letter.

Sincerely,

John Walsh

John G. Walsh
Acting Comptroller
Office of the Comptroller of the Currency

Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System

Martin J. Gruenberg

Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation

Leland A. Strom

Leland A. Strom
Chairman and CEO
Farm Credit Administration

Edward J. DeMarco

Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

Attachment

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