AFR Americans for Financial Reform

June 22, 2016

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution NW
Washington, DC 20551

RE: Comments on Single Counterparty Credit Limits for Large Banking Organizations (RIN 7100-AE8)

To Whom It May Concern,

Americans for Financial Reform ("AFR")[1] appreciates the opportunity to comment on the Federal Reserve Board's (the "Board") Notice of Proposed Rulemaking ("Proposed Rule" or "Proposal") on the above-mentioned rule.

Section 165 of the Dodd-Frank Act mandates the imposition of single counterparty credit limits (SCCL), and significantly expands the range of exposures that are captured under such limits. This Proposed Rule is a re-proposal of the Board's original 2011 proposal regarding credit exposure limits, and makes a number of changes to the original proposal.

While we support the general direction of this proposal, we are concerned that a number of elements in the proposal will lead to an excessively high level of permitted credit exposure:

- First, the proposed limit of 15% of Tier 1 Capital for exposures of a systemically important financial institution (SIFI) to another major counterparty (inter-SIFI exposure) is too low, as it does not take into account the greater social costs of the failure of a systemically important institution as compared to a smaller institution.

- Second, permitting the full netting of derivatives and repo exposures for the purposes of determining credit exposures inappropriately understates credit exposures and can lead to the counterintuitive result that a larger number of gross derivatives transactions with a counterparty can reduce the measured credit exposure to that counterparty. There are also issues with the exposure metric for derivatives, particularly for credit default swaps.

- Third, it is inappropriate to exempt all sovereign exposures weighted at zero under the Standardized Approaches in U.S. capital rules from the credit exposure limit.

[1] Americans for Financial Reform is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/.

If these issues are not addressed in the Final Rule, they will likely lead to a situation where certain banks, particularly systemically important institutions that make heavy use of derivatives, are permitted excessive levels of credit exposure. This is especially true since the 'base' levels of credit exposure permitted for large institutions under these rules (up to 25 percent of Tier 1 capital for a single counterparty and 15 percent of Tier 1 capital for a major counterparty) are already high, and a broad range of collateral and hedges are permitted. We discuss these issues in somewhat greater detail below.

However, there are also a number of important positive elements to the Proposed Rule. These include:

- The expansion of the definition of related entities for determining how exposures to a single counterparty are aggregated, and the use of an economic interdependence test to determine when it is appropriate to aggregate non-consolidated entities.

- The limitation of exposure-reducing guarantees and hedges to 'eligible guarantors', for both guarantees and credit default swaps.

- The various forms of look-through treatment for exposures to special purpose vehicles (SPVs) and funds, involving both the assets underlying the SPV and third parties who might be supporting the SPV.

We also support the exclusion of qualified central counterparties (QCCPs) from the credit exposure limit, as the purpose of a CCP as a risk management entity is precisely to aggregate and net exposures. The mutualization of risk among CCP members also requires members to assume additional credit exposures.

Below, we discuss in somewhat greater detail the issues with the rule referenced above.

<u>Credit Exposure Limits for Large and Systemically Important Institutions are Too High</u>

The proposal applies a lower SCCL of 15 percent of Tier 1 Capital to exposures between two different systemically important financial institutions (SIFIs), as compared to 25 percent of Tier 1 Capital for exposures involving other large banks. We agree with the Board that it is appropriate to establish a lower limit for inter-SIFI exposures than for other exposures, but feel that the 15 percent limit is too high.

The 15 percent limit is justified by the analysis accompanying the rule, which finds that due to the greater correlations between financial outcomes at systemically important institutions a lower SCCL for inter-SIFI exposures is necessary to equate the probability of failure between the two types of institutions. However, this analysis falls far short of a cost-benefit analysis, or even a cost-benefit approach, to setting credit exposure limits for SIFIs. While it equates the probability of failure caused by inter-SIFI exposures to the probability of failure at non-SIFIs, it does not equate the expected social losses created by such failures. The economic damage created by multiple SIFI defaults would likely be catastrophic, and much greater than the economic damage created by the failure of a non-SIFI. Therefore, in order to maximize social benefits the

probability of a bank failure involving multiple SIFIs should be lower than that of a non-SIFI, not equal to it. This would argue for a SCCL that is lower, likely much lower, than the 15 percent level proposed in this rule.

The Board itself is clearly aware of this issue and freely admits that its own analysis implies that the SCCL for inter-SIFI exposures should be lower than 15 percent[2]:

> "An additional consideration that is not considered explicitly in the context of the white paper's credit risk model, but which should influence the calibration of the credit limit between major covered companies and major counterparties, is the relative difference in adverse consequences arising from multiple SIFI defaults relative to the default of a SIFI and non-SIFI counterparty. The financial stability consequences of multiple SIFI defaults caused by the default of a SIFI borrower and the resulting default of a SIFI lender are likely substantially greater than the adverse consequences that would result from the default of a single SIFI lender and a single non-SIFI borrower. As a result, there is a compelling rationale to require that credit risk posed by inter-SIFI credit extensions be materially smaller than that posed by credit extensions between a SIFI lender and non-SIFI borrower. This consideration suggests that an appropriate inter-SIFI single - counterparty credit limit would be even lower than the 15 percent limit suggested by the calibrated credit risk model that is presented in the white paper."

Given this clear recognition of the issue, we find it baffling that the Board has not chosen a more stringent limit on SCCL for inter-SIFI exposures, and recommend that the 15 percent limit be reduced. In addition, the 15 percent limit is effectively higher than the 10 percent limit for inter-large bank exposures in the 2011 proposed rule.[3]

Question 12: Should the Board consider developing aggregate exposure limits to certain catgegories of firms?

We support the idea of developing aggregate exposure limits to particular categories of firms, particularly other types of financial entities. This could and should go beyond major counterparties to encompass other types of financial entities. A market maker role could still be accommodated by exempting very short term exposures, such as the intra day exposure exemption in this proposal. The limitation on individual entity exposures can fail to capture connections between highly correlated groups of entities, such as for example hedge funds pursuing crowded trades. However, significant analytic work will be necessary to determine how to design aggregate exposure limits.

Derivatives Exposures Are Inappropriately Reduced In The Proposed Rule

Derivatives exposures are one of the major potential channels of contagion within the financial system. Exposures are highly concentrated in a limited network of systemically important

---

[2] CFR 14334

[3] Although the 2011 limit was applied to total capital stock rather than Tier 1 capital alone, an industry analysis finds that 10 percent of total capital stock is generally a lower figure than 15 percent of Tier 1 capital – see Davis Polk Visual Memorandum on Single Counterparty Credit Limits

dealers, and such concentration creates enormous contagion risk should a dealer fail.[4] Policies aimed at diversifying risk and interconnection among systemically important institutions should place a high priority on targeting derivatives exposures.

The choices in this rule are disappointing in this context. The Proposed Rule measures derivatives exposures based on fully netted market valuations, basing exposure on fully netting all the derivatives contracts held under a single master netting agreement. This can gravely underestimate potential losses in case of a counterparty failure. As shown in the Lehman case, it is questionable whether all the assumptions of closeout netting would operate in bankruptcy.[5] In a bankruptcy closeout situation a firm may also be exposed to non-netted losses due to intraday timing of derivatives settlement.

Closeout netting also permits a firm to net very dissimilar derivatives exposures, and because such exposures need not be correlated the net position may change radically from day to day, particularly under conditions of market stress. The fact that this Proposed Rule requires larger U.S. banks to calculate compliance with the SCCL on a daily basis is helpful in this regard. But under the Proposed Rule some larger financial entities (such as foreign banking organizations) need only comply on a quarterly basis. There is no reason to believe that if netted derivatives exposures are compliant with credit limits at one point in time in a quarter (e.g. end of quarter) that they will be compliant throughout the quarter.

The use of closeout netting also cuts against the fundamental purpose of counterparty credit limits because it may result in an entity reducing its net exposures against a single counterparty by adding additional derivatives transactions with that counterparty that increase gross exposures. This means that credit limits may actually encourage *increased* concentration of transactions with a single counterparty. The measurement of derivatives risk exposure on a net basis is one reason that gross derivatives exposures have become so concentrated in a small number of centralized dealers, since these dealers can enormously reduce their measured exposures for regulatory purposes by offsetting all their transactions with a single counterparty.

Further, beyond the issue of closeout netting, the use of market valuations to calculate exposures fails to capture potential exposures in a stress situation. This problem is compounded if exposures are also permitted to be netted based on correlation-based hedging, which is given increased scope under the SA-CCR netting method proposed by the Basel Committee. Such correlation assumptions tend to fail under conditions of market stress. We would urge the Board not to permit derivatives exposures to be reduced still further based on correlation assumptions such as those proposed in the SA-CCR.

An additional problem in derivatives exposure measurements under the Proposed Rule is the decision to permit absolute credit risk exposures to be reduced using credit default swaps or equity swaps. As the Proposed Rule explains (CFR 14335):

---

[4] Markose, Sherri, "Systemic Risk From Global Financial Derivatives: A Network Analysis", International Monetary Fund Working Paper 12-282, 2012. Available at https://www.imf.org/external/pubs/ft/wp/2012/wp12282.pdf

[5] Lubben, Stephen J., "Lehman's Derivative Portfolio". December 2, 2015, Seton Hall Public Law Research Paper. Available at SSRN: http://ssrn.com/abstract=2698234

> "In general, any reduction in the exposure amount to the original counterparty relating to the eligible collateral or eligible protection provider would result in a dollar-for dollar increase in exposure to the eligible collateral issuer or eligible protection provider (as applicable)….However, in cases where a covered company hedges its exposure to an entity that is not a ''financial entity'' (a non-financial entity) using an eligible credit or equity derivative, and the underlying exposure is subject to the Board's market risk capital rule (12 CFR part 217, subpart F), the covered company would calculate its exposure to the eligible protection provider using methodologies that it is permitted to use under the Board's risk-based capital rules."

The dollar-for-dollar transfer of exposure to the protection provider is entirely appropriate on a common sense basis. It means the rule does not actively create an incentive to transfer risk to third parties. But the exposure to the protection provider calculated using the Board's risk-based capital rules is likely to be much less than dollar-for-dollar, as the risk based capital rules do not require derivatives to be measured at their full notional value. Permitting this loophole in the exposure calculation means that this rule creates an active incentive for the bank to transfer risks taken in real economy lending to third parties offering credit derivatives. Such risk shifting reduces incentives for banks to develop underwriting knowledge of their counterparties and increases the complexity of our financial system. We urge the Board to remove this loophole.

Zero Weighted Sovereign Exposures Should Not Be Completely Exempted From The Rule

The Proposed Rule would exempt from coverage exposures to sovereign entities that are weighted at zero under the standardized risk-based capital rules. As we understand it, these rules make use of the OECD Country Risk Classifications (CRC), and weight at zero countries that are given a CRC rating category of zero. This group includes all High Income and Eurozone countries with no discrimination made between them. Thus, Greece, Spain, Italy, or Portugal would receive the same rating as Germany, Switzerland, or Japan and all would be rated more highly than e.g. China.

The OECD specifically warns that these classifications are not equivalent to credit ratings and do not assess overall credit risk for exposures to that country. Experiences of recent years have clearly demonstrated that excessive exposures to Eurozone countries can indeed be risky. We believe a blanket exemption from the rule for all countries that have a CRC rating of zero is misguided and urge the Board to find an alternative.

Thank you for the opportunity to comment on this Proposed Rule. If you have any questions, please contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- AARP
- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Center for Effective Government
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Green America

- Greenlining Institute
- Good Business International
- Government Accountability Project
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Home Defenders League
- Information Press
- Institute for Agriculture and Trade Policy
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lawyers' Committee for Civil Rights Under Law
- Main Street Alliance
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Council of Women's Organizations
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Urban League
- Next Step
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council

- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalists for a Just Economic Community

List of State and Local Partners

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation, NY
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG

- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville AR
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX

- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- New Economy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis MN
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida

- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Phoenix AZ
- UNET