

Statement for the Record

On behalf of the

American Bankers Association

before the

Committee on Agriculture

United States House of Representatives



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October 12, 2011

Chairman Lucas, Ranking Member Peterson, and members of the Committee, the American Bankers Association (ABA) appreciates the opportunity to submit this statement for the record on legislative proposals amending Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The ABA represents banks of all sizes and charters and is the voice of the nation's \$13 trillion banking industry and its two million employees.

ABA appreciates the efforts of this Committee to ensure that implementation of the derivatives title of the Dodd-Frank Act agrees with the intent of the Congress. ABA has consistently supported the objective of increasing transparency and appropriate supervision of credit default swaps and other financial products of systemic importance. Several pieces of legislation being reviewed by the Committee today achieves that goal and also preserves the ability of banks to serve as engines for economic growth and job creation.

The Committee is considering today multiple pieces of legislation that would further define and clarify elements of Title VII of the Dodd-Frank Act including the following:

- The Discussion Draft would clarify the definition of a swap dealer and the clearing exemption for certain banks, savings associations, farm credit system institutions, and credit unions. Among other things, it would mandate a clearing exemption for institutions with an asset threshold of \$30 billion or less. It would also include an alternative clearing exemption for institutions with an aggregate uncollateralized outward swaps exposure plus aggregate potential outward swaps exposure that does not exceed \$1 billion. Moreover, the legislation would modify the language for swaps made in connection with loans. ***ABA believes that the Discussion Draft's small institution exclusion is a significant improvement, as is the clarity the legislation would provide for the existing exclusion from the swap dealer definition for transactions in connection with originating loans. We remain opposed to excluding the \$230 billion Federal Farm Credit System from any provisions of Title VII of the Dodd-Frank Act because it is a Government Sponsored Enterprise.***
- H.R. 2682, the Business Risk Mitigation and Price Stabilization Act of 2011, would clarify that end users would not be subject to margin requirements for uncleared swaps. However,

the legislation would limit the margin exemption to end users that are *not* financial entities. ***ABA supports an end-user exemption from margin requirements for uncleared swaps and believes that all end users – including banks that use swaps to hedge or mitigate risk – should be exempt.***

- A second Discussion Draft amends the Commodity Exchange Act to clarify the definition of a swap dealer would include additional criteria for determining which persons may be characterized accurately as swap dealers. Specifically, the legislation would exclude from the definition of a swap dealer those persons engaging in swaps transactions for the purpose of hedging or mitigating commercial risk or that are ancillary to a person's regular business as a producer, processor, handler, or commercial user of certain products. The Discussion Draft also adds a specific gross notional amount threshold test to the existing Dodd-Frank Act *de minimis* exception from the definition of a swap dealer. ***ABA supports establishing clearly defined criteria for the de minimis exception and stands ready to work with the Committee to develop appropriate standards for this exception.***
- H.R. 2779 would exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Act. H.R. 1840 would improve consideration by the Commodity Futures Trading Commission (CFTC) of the costs and benefits of its regulations and orders. ***ABA supports exempting inter-affiliate swaps from many of the anticipated swap regulations, as failing to do so would undermine bank internal risk management procedures and distort market information. ABA also supports a stronger requirement for full assessment of the costs and benefits of CFTC regulations.***

The remainder of this statement provides more detail on ABA's position on these bills.

Banks With Limited Swap Activities Should Be Exempt From Clearing Requirements

ABA has a diverse membership including banks of all sizes that use swaps in a variety of ways depending on the complexity of their business activities. Hundreds of our member banks use swaps to mitigate the risks of their *ordinary* business activities. Margin and clearing requirements would make it difficult or impossible for many banks to continue using swaps to hedge the interest rate, currency, and credit risks that arise from their loan, securities, and deposit portfolios. Such requirements would increase the risk in the system, not reduce it, and reducing risk is the primary purpose of hedging.

The vast majority of banks use derivatives as part of the delivery of fixed-rate loans or long-term financing to customers, *not* as a means for speculation. For example, a bank will use swaps to hedge the interest rate risk on its own balance sheet, thus lowering the bank's risk in providing customer loans. Moreover, interest-rate swaps help to provide long-term fixed-rate financing to manufacturers, small businesses, universities, not-for-profit organizations and other bank customers, thus helping *customers* safely manage their interest rate risk and focus on their core business rather than the prospect of rising interest rates.

Many banks cannot afford the expense of establishing and maintaining a clearing relationship for the limited amount of swaps transactions that they undertake in the service of their customers. A costly clearing requirement imposed on these institutions would adversely affect them and their business customers as they try to weather an uncertain economy. Without passage of several pieces of legislation before the Committee today, or proper implementation of the Dodd-Frank Act by the regulatory agencies, the result will be reduced credit options for many businesses and organizations across the country that are working to create jobs.

As we have stated in previous testimony to this Committee, ABA believes that:

- ***Banks with limited swaps activities should be exempt from the new clearing requirements in the same way as other “end users”***
- ***All common lending practices should be included in the exemption from the swap dealer definition for swaps entered into in connection with originating a loan***
- ***End users – including banks with limited swaps activities – should not be subject to margin requirements***

The ABA believes that the Discussion Draft regarding the small institutions exclusion from clearing is a significant improvement to underlying law. The Discussion Draft recognizes that many banks use swaps in the same way as other end users, to hedge or mitigate commercial risk. Moreover, banks using swaps to hedge or mitigate commercial risk have standard risk management practices that are subject to regulatory oversight (including on-site examinations every 12 to 18 months) and they have explicit legal limits on the overall credit exposure that they can have to any individual or entity. Banks engaging in these limited swaps activities should be exempt from the clearing requirements because they do ***not*** pose a risk to the swaps market or the safety and soundness of the banks. In fact, banks and savings associations below the Discussion Draft’s \$30 billion asset threshold for a clearing exemption account for ***only 0.09 percent*** of the notional value of the bank swaps market as of June 2011.

The Discussion Draft provides needed certainty to the underlying law for banks that enter into swaps transactions in connection with originating loans for customers. Banks commonly enter into swaps with customers so that customers can hedge their interest rate or loan-related risks. While some swaps are entered into simultaneously with loans, many swaps are entered into before or after a loan is made. For example, it is common for a customer to enter into a swap to lock in an interest rate in anticipation of a future loan. The Discussion Draft ensures that these essential risk-mitigating services conducted as part of the loan making process are not brought into the swap

dealer definition. In this way, the Discussion Draft will protect a variety of credit options for businesses of all sizes working to create jobs and grow the economy.

The ABA is concerned that the swaps exposure measurement alternative proposed in the legislation would constitute an undue administrative burden for banks. Although we agree that a risk-based measurement is appropriate for determining which institutions may qualify for the exclusion, we are concerned that the proposed measurement would be extremely cumbersome for banks to undertake. Banks with limited swaps activities are least able to afford additional regulatory or administrative burdens related to their swaps transactions and are likely to stop using swaps altogether if costs or complexities are significantly increased. As a result, they would lose an important risk management tool. The ABA will continue to work with the Committee on alternative risk-based measurements as the legislative process moves forward.

The \$230 Billion Federal Farm Credit System Should Not Be Given Special Treatment

The ABA would like to reiterate that it strongly disagrees that the \$230 billion Federal Farm Credit System (FCS) should be exempted from an asset test regarding their derivatives activities. We urge this Committee to reject its request for special treatment. The Federal Farm Credit System is a tax-advantaged, retail lending, Government Sponsored Enterprise (GSE). The Federal Farm Credit System suggested to this Committee that regulators “look through” their corporate structure to the smallest entities that make up the System, the retail lending associations. Each of these entities are *jointly and severally liable for each other’s financial problems*. The FCS proposes that the joint and several liability requirement be overlooked so that it may be considered a collection of small entities, when in fact this is not the case.

The Federal Farm Credit System presents the same kind of potential liability to the American taxpayer as other GSEs. Taxpayers are the ultimate backstop in the event that the Federal Farm Credit System experiences financial problems. In fact, this has already happened. The near collapse of the Federal Farm Credit System in the late 1980s – which was a result of irresponsible farm lending by Federal Farm Credit System institutions – foreshadowed what taxpayers would confront more than twenty years later with the housing GSEs. At that time, the Federal Farm Credit System received \$4 billion in financial assistance from the U.S. taxpayer. ***Therefore, due to its enormous size and the potential risk it poses to the economy, we urge this Committee to reject the Federal Farm Credit System’s arguments for exemptions from the derivatives title of the Dodd-Frank Act and ensure that the implementation of these requirements by regulators does not permit such a look-through.***

End Users Should Not Be Subject to Margin Requirements for Uncleared Swaps

The Dodd-Frank Act does not require regulators to impose margin requirements on end users and the legislative history makes it clear that Congress did not intend to impose margin requirements on end users. Nonetheless, end users currently face uncertainty about whether they will be subject to margin requirements and this legislation would provide much-needed clarity.

The margin requirements are intended to offset the greater risk to swap entities and the financial system from uncleared swaps. However, imposing margin requirements on end users would discourage the use of swaps to hedge or mitigate risk, so it would both increase risk in the system and vitiate the end-user clearing exemption.

Furthermore, the vast majority of banks use swaps to hedge and mitigate the risks of their ordinary business activities, just as other end users do. Banks are also subject to comprehensive regulation and use swaps to meet regulatory expectations for asset-liability management. Adding initial and variation margin requirements and imposing clearing requirements would make it difficult or impossible for many banks to continue using swaps to hedge the interest rate, currency, and credit risks that arise from their loan, securities, and deposit portfolios. The result would increase risk in the system, not reduce risk, which is the primary purpose of hedging.

If the Committee wants to make a distinction between the margin requirements for bank end users and other end users, then we urge the Committee to consider imposing only variation margin for end-user banks rather than both initial and variation margin requirements. Current market practice is for swap counterparties to negotiate whether any collateral or margin requirements should be required and banks are already required to periodically reassess changes in the value of their assets and liabilities. Accordingly, at most end-user banks should be subject to mark-to-market variation margin requirements as they reassess the value of any negotiated collateral. The ABA stands ready to assist the Committee if it decides to distinguish between margin requirements for bank end users and other end users.

ABA Supports Clearly Defined Criteria for the De Minimis Exception

The ABA believes that the Discussion Draft clarifying the definition of a swap dealer is an important step forward. The legislation proposes clearly defined criteria for the *de minimis* exception, a goal which ABA fully supports. It is important for Congress to give clear guidance to the regulators on this point to ensure that institutions presenting nominal risk to the system are not

saddled with undue costs and complications. ABA will continue to work with the Committee on the criteria for an appropriate *de minimis* exception.

ABA Supports Full Assessment of the Costs and Benefits of CFTC Regulations

The ABA supports H.R. 1840, legislation providing for a full assessment of the costs and benefits of the Commodity Futures Trading Commission (CFTC) regulations. Regulatory burden on the banking industry has grown dramatically as a result of the Dodd-Frank Act and is stretching the resources of banks across the country. The median-size bank has just 37 employees and is struggling to pay for new auditing, legal, and compliance costs resulting from a mountain of new regulations. H.R. 1840 would ensure that the best possible assessment is made of the costs and impacts of new regulations so that regulated entities are not subject to unnecessary costs that outweigh any potential regulatory benefit.

ABA Supports Exempting Inter-Affiliate Swaps From Certain Regulatory Requirements

The ABA believes that H.R. 2779, legislation exempting inter-affiliate swaps from certain regulatory requirements, significantly improves underlying law. For certain financial institutions, inter-affiliate swaps are an important tool for accommodating customer preferences and managing interest rate, currency exchange, or other balance sheet risks that arise from the normal course of business. Inter-affiliate swaps do not create additional counterparty exposure and should not be subject to the same rules intended for swaps entered into with a third party. In addition, H.R. 2779 would require reporting of inter-affiliate transactions. This requirement would *not* add relevant market information. ***Rather, it would be duplicative and would distort market information.*** ABA would like to continue to work with the Committee on this reporting provision going forward.

Conclusion

ABA thanks the Committee for its strong leadership in this area. The Committee's efforts will facilitate better functioning of credit markets and maximize credit options for businesses large and small that are critical to job growth. ABA believes that treating end-user banks the same way as other end users is an essential component of this effort. ABA member banks, like commercial end-users, use swaps to mitigate the risks of ordinary business activities and should be exempted from mandatory clearing and margin requirements.