

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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July 21, 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 derivatives rules and their impact on businesses – including banks. 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 being made by this Committee to oversee the implementation of the Dodd-Frank Act with regards to derivatives regulation and to ensure that implementation agrees with the intent of the Congress. Indeed, ABA has consistently supported the objective of increasing transparency and appropriate supervision of credit default swaps and other financial products of systemic importance. However, it is critical that regulatory implementation preserves banks’ ability to serve as engines for economic growth and job creation by providing credit to businesses and offsetting the customary risk these transactions create through internal risk management functions.

ABA is very concerned about new rules being formulated to implement the Dodd-Frank Act that would add swap margin and clearing requirements for all banks unless the regulators provide an exemption. If not crafted properly, the new swaps rules could also discourage banks from offering customers the option to use swaps to hedge their loan-related risks. Our members and their customers use swaps to manage and mitigate the risks inherent in everyday business transactions. Banks underwrite all loans and swaps using the credit risk assessment standards that apply to the overall lending relationship with that customer. Loans and swaps may be collateralized by, among other things, real property, equipment, inventory, or accounts receivable. Alternatively, some loans and swaps may be cross-collateralized with another loan or may not be collateralized at all. ***This is the essence of commercial lending – banks assess credit and market risk of the borrower, negotiate loan terms, and accept the repayment and market risk.***

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.*** This would increase the risk in the system, not reduce risk, which is the primary purpose of hedging.

There are three points we would like to make today:

- **Small banks should be exempt from new clearing requirements just as other “end users” are.**
- **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.**

Before we explain these points in detail, we would like to address a separate but related concern. In prior testimony before this Committee, the \$231 billion Federal Farm Credit System (FCS or System) argued that they should be exempted from an asset test regarding their derivatives activities. We urge this Committee to reject this request.

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 would like this Committee to now ignore their joint and several liability to each other and would like to be treated as if they were a multitude of small entities. They are not.

The Federal Farm Credit System presents the same kind of potential liability to the American taxpayer as other GSEs – taxpayers are the ultimate back stop should the Federal Farm Credit System develop financial problems. In fact, this has already happened. An earlier near collapse of the Federal Farm Credit System in the late 1980s as a result of irresponsible farm lending 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 Dodd-Frank.

I. Small Banks Should be Exempt from New Clearing Requirements Just as Other “End Users” Are

The Dodd-Frank Act mandates new clearing requirements for swaps. If these requirements were applied equally to all financial institutions – regardless of risk – the result would limit their ability to hedge or mitigate risk. Many banks would not be able to afford the additional burdens of such a broad application of the new law. This is why it is critical that regulators take into account the flexibility the Dodd-Frank Act gives to provide a clearing exception for “end users” that use swaps to hedge or mitigate risk. Indeed, the Dodd-Frank Act *requires* regulators to consider whether to exempt small banks from the new mandatory swaps clearing requirements.

Absent an exemption, even small banks would be deemed “financial entities,” and would not be eligible for the exception from clearing requirements available to other end users. Unless the regulators exercise their exemptive authority, banks that have limited swaps activities – including some of the smallest institutions in the country – will have to comply with the new clearing requirements even if they use swaps as a normal part of their business strategy to hedge or mitigate commercial risk.

Many banks use swaps the same ways that other end users do. For example, banks use swaps to hedge interest rate risk both on their own balance sheet and to provide long-term fixed rate financing to commercial borrowers. The SEC recognized this activity and stated that it believes that small banks should be exempt from clearing requirements as end users

Small bank swap transactions account for a very small part of the overall swaps market. They generally transact in smaller notional amounts and need to customize swaps to loans that they originate. An appropriate risk-based approach to clearing requirements should take into account not just total assets, but also the risk that an institution's swaps activities pose for the overall swaps market and to that institution. Even banks and savings associations with \$30 billion or less in assets account for *only 0.09 percent* of the notional value of the bank swaps market as of March 2011. Moreover, banks using swaps to hedge or mitigate commercial risk have standard risk management practices that set limits on exposure to swap dealers and also are subject to regulatory oversight. 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 nor do these swaps activities pose a risk to the safety and soundness of the banks.

If appropriate exemptions from clearing requirements are not established, small banks would be discouraged from using swaps. The time and expense to establish a clearing agency relationship as well as the increased complexity and costs would be prohibitive for many institutions that use swaps sparingly. They are least able to afford the overhead costs required to establish a clearing relationship and pay the ongoing clearing fees. Further, they may need to establish multiple clearing relationships depending on their business model.

If a bank with limited swaps activities could no longer afford to engage in swaps transactions, then it would not only increase costs and risk for its customers but also decrease the institution's ability to manage its own financial risk. It would also place these banks at a competitive disadvantage relative to larger financial entities. The result would be reduced credit options, which would adversely affect small businesses – and many other entities – at precisely the time when we need them to serve as an engine for economic growth and job creation.

II. 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

The Dodd-Frank Act exempts banks and other insured depository institutions from the definition of swap dealer if they enter into “a swap with a customer in connection with originating a loan to that customer.” Banks commonly enter into swaps with customers so that customers can hedge their interest rate or loan-related risks.

The joint CFTC and SEC rule proposal on the swap dealer definition asks for comment on whether this exemption should be limited to a swap entered into contemporaneously with the loan.

Limiting the exemption to swaps and loans entered into at the same time would be too narrow and would not capture common swap transactions used to hedge and mitigate 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. If a loan has a variable interest rate, it is also common for a customer to enter into a swap during the course of the loan to convert to fixed-rate payment obligations. A loan and swap may also be purchased by another lender or they may be assigned and

novated if the lender stops lending. These are common loan transactions and should be exempt from the swap dealer definition.

If these common lending practices are not taken into consideration, a bank that is not excluded from the swap dealer definition would have to create a separate entity to conduct swaps activities, because swap dealers are ineligible for “federal assistance,” including FDIC insurance. Forming an affiliate to continue engaging in swaps would be expensive and require additional regulatory capital, so it would not be an option for most banks, particularly small ones. Instead, most banks would likely stop using swaps in connection with originating loans, *which would raise costs for borrowers and discourage banks from making certain types of loans that are common today.*

Lending and financial risk management are vital to our economic stability and growth. Accordingly, the exemption from the swap dealer definition for swaps entered into in connection with originating a loan should be broad enough to ensure that banks are not hindered from engaging in common loan-related hedging transactions.

III. End Users – Including Banks with Limited Swaps Activities – Should Not Be Subject to Margin Requirements

The Dodd-Frank Act mandates that the prudential regulators, CFTC, and SEC impose margin requirements on swap entities engaging in uncleared swaps transactions. Fortunately, the statute does not require regulators to impose the margin requirements on end users that use swaps to hedge or mitigate commercial risk. Indeed, the CFTC has issued a rule proposal that would not impose margin on end users, but rather would allow end users to continue negotiating any collateral and margin on loans and swaps and even to continue participating in unsecured loans and swaps. This is consistent with the clearing exception for end users, which was intended to ensure that end users can continue to hedge market risk without incurring burdensome costs.

The prudential banking regulators and the CFTC recently issued rule proposals that acknowledge that swaps with non-financial entities pose less risk to swap entities and the U.S. financial system than swaps with other types of entities. Even so, the prudential regulators’ proposed margin rule would impose margin requirements on end users *despite a finding that they pose minimal risk.* We believe that the CFTC’s decision not to impose margin requirements on non-financial end users that use swaps to hedge or mitigate commercial risk is more consistent with statutory language and intent.

As we note above, *banks with limited swaps activities are end users* and use swaps to hedge interest rate risk on their balance sheet or loan exposure just as other end users do to hedge or mitigate risk from their ordinary business activities. Adding both initial and variation margin requirements would make engaging in swaps prohibitive for banks with limited swaps activities just as requiring clearing would. If regulators do impose margin on bank end users, then they should not impose any initial margin requirements but rather require only mark-to-market margin on any collateral agreed upon by the swap counterparties.

Regulators should take into account current market practice in establishing margin requirements and should allow all end users – including banks with limited swaps activities – to continue to negotiate any collateral or margin terms for uncleared swaps.

Conclusion

ABA member banks use swaps to mitigate the risks of their ordinary business activities, just like their business counterparts. Banks that engage in swaps transactions that are substantially similar to the types of transactions used by other businesses should be included in the definition of “end user” and exempted from clearing and margin requirements. Not doing so would make it prohibitively expensive to engage in these ordinary business activities and restrict banks from making certain types of loans at a time when lending is most needed.