



August 13, 2015

The Honorable Elijah E. Cummings  
Ranking Member  
Committee on Oversight and Government Reform  
United States House of Representatives  
Washington, DC 20515

Dear Representative Cummings:

Thank you for your letter dated July 16, 2015, regarding swaps derivatives transactions and section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or DFA). Specifically, your letter requests certain information about the derivatives market and the Office of the Comptroller of the Currency's (OCC) implementation of section 716, as amended by section 630 of the 2015 Consolidated and Further Continuing Appropriations Act.

Since its beginnings in the early 1980's, the over-the-counter (OTC) derivatives market has grown dramatically in size, scope, and complexity. While derivatives transactions are sometimes highly speculative in nature, the vast majority of transactions are intended to manage risk and hedge exposures. The foundation of the derivatives markets is the ability for two parties to agree to, and firmly contract today, for the forward price of some future deliverable. The ability to establish a forward price creates certainty and therefore reduces risk.

A wide spectrum of end users avail themselves of derivatives markets to create certainty and reduce risk. Investors and borrowers can fix rates of interest. Farmers can establish predictable returns before crops are harvested. Airlines can mitigate the volatility of fuel prices. Manufacturers can manage costs of raw material inputs. International commerce is facilitated by controlling foreign exchange risks. Pension funds can mute the volatility of returns in equity or debt markets. OTC derivative contracts are highly flexible instruments, customizable to a wide variety of end user needs.

At the same time, derivatives activity does create certain types of risk to market participants. The largest risk created in derivative contracts is counterparty credit risk, arising from the possibility that the counterparty may default on amounts owed on a transaction. The situation at AIG Financial Products in which tens of billions of unsecured counterparty credit exposure developed at the height of the crisis is a noteworthy example of this risk. Derivatives markets also present the potential for operational risks, for example, where financial models are improperly calibrated or where fraudulent or unauthorized transactions are entered into. As with

other financial products, derivatives can also lead to serious compliance and reputation issues if sold in an inappropriate manner.

Since the recent financial crisis, the OCC and other federal financial regulatory agencies have implemented a number of Dodd-Frank Act requirements, which have changed the operation of the OTC derivatives markets in a manner that has substantially reduced risk in the system. Counterparty credit risk has been significantly reduced through collateralization of exposures with cash and high quality financial instruments. Financial collateral is posted both as initial margin at trade inception and variation margin over the life of contracts as exposures fluctuate in response to changing market conditions. Initial margin and variation margin are features of both centrally cleared transactions mandated under the Dodd-Frank Act and non-cleared transactions under the proposed Swaps Margin Rule (most major market participants are already moving to conform to the principles outlined in the notice of proposed rulemaking). Other market developments such as trade compression have also contributed to a material decline in outstanding open positions.

Separately, on August 4, 2015, the OCC issued guidance entitled “Quantitative Limits on Physical Commodity Transactions” clarifying expectations for bank holdings of physical commodities as hedges for commodity indexed derivative transactions -- transactions that would have been pushed out under section 716 as originally enacted -- that will sharply limit bank activity in this area. In addition, the OCC’s enforceable “Heightened Expectations” guidelines, issued under Part 30 of our regulations, demand much tighter standards for corporate governance generally but particularly in the areas of risk appetite, risk framework, and risk controls. The cumulative effect of these regulatory actions has been to reduce the systemic risk presented by derivatives markets. We note that the notional value of outstanding derivatives contracts has declined by 12 percent, from \$231.1 trillion to \$203.1 trillion since 2010, while the collateral held against market exposure of derivatives has increased by 14 percent or \$47 billion. As noted in the OCC’s Quarterly Trading and Derivatives report, there has been a 35 percent increase in collateralization of net counterparty credit exposures, rising from 60.4 percent of risk at year end 2009 to 81.2 percent at year end 2014. This increased collateral coverage is due to the combined impact of two key provisions of the Dodd-Frank Act: the swaps margin rule and migration of businesses to central clearinghouses.<sup>1</sup>

In addition, the Volcker Rule reduces bank proprietary trading activity, sizes dealer market making activity to customer demand, and requires banks to deliver a range of metrics to permit supervisors to monitor risk at the trading desk level. Finally, it should also be noted that a general increase in bank capital requirements provides further mitigation of risks to the financial system across all bank activities.

Your letter includes several specific questions that I will answer below.

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<sup>1</sup> Given that exposures to corporates and sovereigns represent 46 percent of industry net counterparty credit exposures and were excluded from mandatory collateral requirements, it is unlikely this ratio will ever be 100 percent.

**Q1: The definitions of the terms “hedging” and “risk management purposes” that your agency will use to determine which swaps can now be made under Section 716.**

**A:** Section 716(a) of the DFA prohibits the provision of federal assistance to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity. This general prohibition is limited with respect to a swaps entity that is also a covered depository institution.<sup>2</sup> Under section 716(d), a swaps entity that is a covered depository institution may engage in certain traditional banking activities involving swaps,<sup>3</sup> as well as hedging and risk management activities, without triggering the federal assistance prohibition.

Section 716 does not define the terms *hedging* or *risk management purposes*. These terms appear in two provisions of section 716. First, section 716(d)(1)(A) provides that the federal assistance prohibition does not apply if a covered depository institution limits its activities to *hedging* and other similar risk mitigating activities directly related to the covered depository institution’s activities. Second, section 716(d)(1)(C)(i) provides that a covered depository institution may act as a swaps entity for structured finance swaps if such structured finance swaps are undertaken for *hedging* or *risk management purposes*.<sup>4</sup>

In general, the OCC views hedging and risk management to mean activities that result in risk reduction or risk control for a bank. Banks routinely enter into a variety of financial transactions in order to manage specific risks that arise from traditional banking activities, including lending, fiduciary services, liquidity management, and financial intermediation.<sup>5</sup> These risks include counterparty or credit risk, currency or foreign exchange risk, market risk, and interest rate risk. The OCC expects that a covered depository institution that engages in the hedging or risk management activities identified in section 716(d)(1)(A) or (C) will do so to reduce or control one or more of the types of risks identified above. Consistent with its prudential supervision of all risk management activities, the OCC will supervise hedging and risk management covered under section 716(d)(1)(A) and (C) to ensure they are conducted in a safe and sound manner and are designed to reduce or control risk. This supervision generally includes review of banks’ risk management policies and procedures, trade documentation, and, if appropriate, correlation analysis and independent testing.

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<sup>2</sup> A *covered depository institution* is defined in section 716(b)(3) as an insured depository institution or a U.S. uninsured branch or agency of a foreign bank.

<sup>3</sup> Section 716(d)(1)(B) provides that a covered depository institution may act as a swaps entity for swaps or security-based swaps, other than a structured finance swap.

<sup>4</sup> Section 716(d)(1)(C)(ii) also provides that the federal assistance prohibition does not apply if each asset-backed security underlying such structured finance swaps is of a credit quality and of a type or category with respect to which the prudential regulators have jointly adopted rules authorizing swap or security-based swap activity by covered depository institutions.

<sup>5</sup> See e.g., Comptroller’s Handbook, *Risk Management of Financial Derivatives* (Narrative – January 1997, Procedures, February 1998).

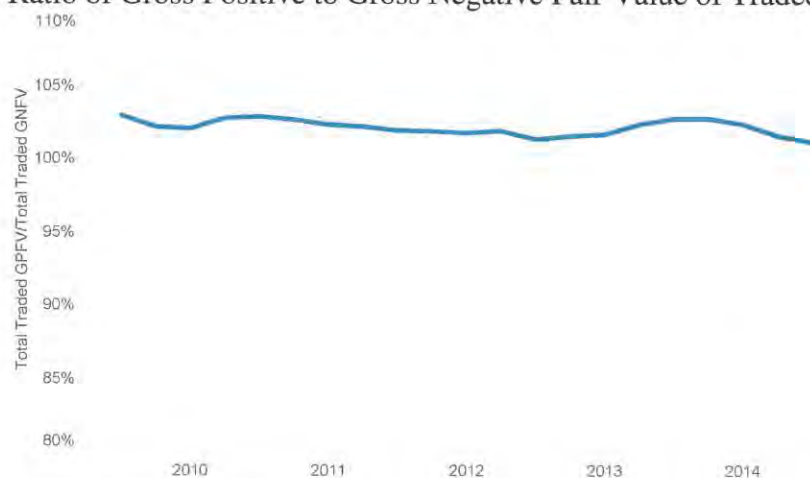


**Q2: The total value of derivatives contracts held by US banks for “hedging” and “risk management” purposes and the total value of swaps derivatives held by US banks for each purpose.**

**A:** Because the terms “hedging” and “risk management” are not defined, it is not possible to answer this question with precision. However, we can use data from the Consolidated Reports of Condition and Income (call report) to shed some light on the question. Banks report derivatives on the call report in two categories: held-for-trading, and not held-for-trading. At the end of the first quarter of 2015, the notional value of derivatives not held-for-trading was \$3.6 trillion, or 1.7 percent of all notional derivatives reported by insured U.S. commercial banks. The fair value of contracts with positive value, not held for trading, was \$76 billion, or 1.9 percent, of the total gross fair value of all derivatives contracts with positive value.

As the OCC’s Quarterly Report on Bank Derivatives Activities report has shown over the years, the lion’s share of derivatives contracts in the banking system are reported as held-for-trading. This is because the large dealers, which have more than 91 percent of all notionals in the insured U.S. banking system, report nearly all of their derivatives contracts as trading. Despite the predominance of contracts reported as held-for-trading, however the vast majority of this activity is for hedging and risk management purposes, as those terms are explained in Question 1. The following chart tracks the ratio of the fair value of receivables and payables on traded derivatives, and illustrates that the governance framework imposed on derivatives activities limits speculative activity. Were this not the case, one would expect to see more significant deviations between the value of contracts with positive and negative fair values.

Ratio of Gross Positive to Gross Negative Fair Value of Traded Derivatives Contracts



Source: Call Reports

At the end of the first quarter of 2015, banks reported gross positive fair value (derivatives receivables) of trading contracts of \$4.067 trillion, 101.3 percent of the \$4.013 trillion gross negative fair value (derivatives payables).

**Q3: The definition of the term “structured finance swap” that your agency will use to determine which swaps trades can now be made under Section 716 and examples of the types of transactions that will now be allowed.**

**A:** The OCC uses the statutory definition of *structured finance swap*. In particular, section 716(d)(2)(A) defines a structured finance swap as a swap or security-based swap based on an asset-backed security (or group or index primarily comprised of asset-backed securities). An asset-backed security is further defined in section 716(d)(2)(B), by cross-reference to the definition of that term in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)).<sup>6</sup>

Examples of structured finance swaps include credit default swaps on collateralized loan obligations, credit default swaps on collateralized debt obligations and credit default swaps on index asset-backed securities. Transactions in these instruments by a covered depository institution will not trigger the federal assistance prohibition only if: (i) the swaps are undertaken for hedging or risk management purposes (*see* Question 1 discussion above); or (ii) prudential regulators jointly issue a rule authorizing the activity based upon the credit quality of the underlying asset-backed security.<sup>7</sup> The prudential regulators have not issued such a rule.

**Q4: Copies of the applications your agency received seeking a delay in the implementation of Section 716, including any supplemental materials provided with these applications.**

**A:** The OCC is committed to being fully open and transparent with respect to its determination that 24 months was the appropriate length of time for the transition period required under section 716(f). Indeed, the OCC’s analysis is set forth in detail in publicly available letters to the relevant institutions.<sup>8</sup>

The OCC is also committed to responding fully to formal requests for documents from Congressional committees and subcommittees that have oversight over the OCC even when the

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<sup>6</sup> Under 15 U.S.C. § 78c(a)(79) of the Act, the term “asset-backed security”—

(A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—

- (i) a collateralized mortgage obligation;
- (ii) a collateralized debt obligation;
- (iii) a collateralized bond obligation;
- (iv) a collateralized debt obligation of asset-backed securities;
- (v) a collateralized debt obligation of collateralized debt obligations; and
- (vi) a security that the SEC, by rule, determines to be an asset-backed security for purposes of this section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company. 15 U.S.C. § 78c(a)(79).

<sup>7</sup> Section 716(d)(1)(C)(ii).

<sup>8</sup> <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/706f.html>.



request encompasses documents that contain privileged, non-public OCC information. With respect to this specific request, several of the banks that provided documents to the OCC under section 716(f) did so under a claim of privilege. Additionally, the banks have asserted that the requested documents are exempt from disclosure under the Freedom of Information Act (FOIA) because the records include trade secrets and commercial or financial information furnished in confidence.<sup>9</sup> Information that is furnished in confidence to the OCC in connection with the OCC's performance of its responsibilities is non-public OCC information.<sup>10</sup> Moreover, because these documents include the banks' deliberative communications concerning the appropriate supervisory treatment for activities of individual banks, the requested documents include information that is subject to the OCC's bank examination privilege. We are concerned that voluntary production of the requested documents may be viewed as a waiver of applicable privileges and may adversely affect the OCC's ability to protect privileged, non-public OCC information from disclosure in litigation or in response to a request under the FOIA.<sup>11</sup> Consequently, the OCC is not in a position to provide copies of the requested applications.<sup>12</sup>

**Q5: The total value of “structured finance swap” transactions conducted by US banks for the last ten years, by bank and by year.**

**A:** There is no data that indicates either the notional or fair values of structured finance swap transactions conducted by U.S. banks. To try to give some insight, however, we can look to data banks report on their securities holdings. Banks report cash-market structured financial products held both in their investment and trading portfolios in Schedule RC-B and RC-D of the call report. Trends in cash market products are likely a useful barometer of activity in the derivatives markets.

As of the first quarter of 2015, insured U.S. commercial banks reported \$83 billion of structured products in their investment portfolios, or 0.52 percent of total assets of all insured U.S. banks and federal savings associations, and an additional \$1 billion in their trading portfolios. Due to significant losses on structured products during the financial crisis, the appetite for such

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<sup>9</sup> 5 U.S.C. § 552(b)(4). This information is also protected under FOIA exemption 8 (records relating to the examination, operations, or condition of financial institutions prepared by, on behalf of, or for the use of any agency responsible for regulation or supervision of financial institutions). 5 U.S.C. § 552(b)(8).

<sup>10</sup> 12 CFR § 4.32(b)(1)(i)(A). Non-public OCC information also includes information that the OCC is not required to release under the FOIA. 12 CFR § 4.32(b)(1).

<sup>11</sup> See *Spears v. First American eAppraiseIT*, 2014 U.S. Dist. LEXIS 167354, 2014 WL 6783737, 3 (D.D.C. 2014) (Holding that the former Office of Thrift Supervision (OTS) did not waive any privileges with respect to documents produced to the Senate Permanent Subcommittee on Investigations in response to a subpoena, because the documents had not been voluntarily produced and the OTS had taken steps to preserve confidentiality of the documents (*i.e.*, the documents were provided under seal in response to a subpoena from a congressional subcommittee). See also, *e.g.*, *Rockwell International Corp. v. U.S. Department of Justice*, 235 F.3d 598 (D.C. Cir. 2001). (No waiver where Department of Justice gave subcommittee documents only after subcommittee expressly agreed not to make the documents public.)

<sup>12</sup> Citibank, N.A. and PNC Bank, N.A. submitted confidential and public (redacted) versions of their applications. We are happy to make the public versions of these applications available upon request.

exposures has virtually disappeared. In 2010, the first year for which data is available for trading portfolios, insured U.S. commercial banks held \$14 billion in structured financial products in their trading portfolios, more than 14 times their current trading portfolio holdings. The OCC believes that, were information on structured derivatives transactions available, it would similarly show a very rapidly declining level of exposures.

**Q6: The total value of swaps US banks would have been required to “push out” under Section 716 as originally adopted.**

**A:** Because the statute provided that the prohibition on federal assistance “shall only apply to swaps or security-based swaps entered into by an insured depository institution after the end of the transition period,” it did not require any existing swap transactions to be pushed out. We can use call report historical information, however, to make a rough generalized estimate of the new swaps activity that banks have historically generated, and that may serve as an estimate of the annual volume of swaps they would have been prospectively required to push out.

Prior to the amendment, section 716 applied to commodity, equity, and most credit derivatives transactions. We can roughly approximate new derivatives transactions that occurred in a year via a framework that adds current maturities (i.e., derivatives that mature within one year) in these product classes to any change in notionals that occurred during that year. There are, of course, other actions and events that can occur, such as trade compression (particularly important for credit derivatives) and transactions that both originate and mature within the same year. Each could cause an estimate using our framework to be understated. Acknowledging that weakness, we roughly estimate that notional derivatives for commodity, equity and credit derivatives increased by \$6.7 trillion in 2012, \$12.2 trillion in 2013, and \$5.0 trillion in 2014. This growth represents 11.8 percent of the total \$203.1 trillion of notionals outstanding. If historical behavior is representative of future behavior, these totals provide a range of estimates for the annual amount of notional derivatives that banks would have been prospectively required to push out.

**Q7: Any estimates concerning the total value of swaps US banks will now be required to “push out” under the revised Section 716.**

**A:** Under section 716, a bank swaps entity triggers the federal assistance prohibition by engaging in certain activities in “structured finance swaps” (*see* response to Questions 1 and 3 above). While that term is defined by statute, it is very difficult to estimate the total value of swaps banks would now be required to “push out.” For example, there is no information in the call report that identifies structured finance swaps. We are therefore unable to make a rough estimate using the framework above (i.e., estimating prospective push-out volumes based upon the existing portfolio and maturities) for commodity, equity, and credit derivatives.

Moreover, as noted above in the answer to Question 5, the OCC believes that the appetite for structured finance swaps has virtually disappeared, as evidenced by the sharp reduction in trading portfolios of structured financial products.

**Q8: Any assessments conducted by your agency regarding the “operational and credit risks” the implementation of Section 716 would have created for US banks.**

**A:** The OCC evaluated assessments made by national banks of operational, credit and other risks as part of its decision that 24 months was the appropriate length of time for the transition period required under the statute. As part of this evaluation, the OCC found that granting a 24-month transition period lowered the probability of operational problems and market disruption that could occur if banks did not have sufficient opportunity to restructure swaps dealing in an orderly manner. The OCC further found that the market disruption that could result from a disorderly restructuring of swaps activities could affect credit and capital markets and cause negative macroeconomic consequences. A detailed discussion of this analysis is available in the OCC’s publicly available transition period letters (*see* footnote 8).

**Q9: Any assessments conducted by your agency regarding the impact of the partial repeal of Section 716 on the risk of taxpayer-funded bailouts of insured depository institutions.**

**A:** The OCC has not made any specific assessments regarding the impact of the partial repeal of the swaps push-out rule on the risk of taxpayer-funded bailouts.

**Q10: Any assessments conducted by your agency regarding the impact of the partial repeal of Section 716 on bank behavior in the swaps derivatives market generally, including an assessment of whether or how the partial repeal of Section 716 increases the risk profiles of major banks.**

**A:** The OCC has not conducted any specific assessments regarding the impact of the partial repeal on bank behavior in the swaps markets. The OCC does believe, however, that there is evidence that trading revenue from commodity, equity and credit products (the “push-out” products) helps to diversify bank trading portfolios, due to the negative correlation between trading revenue from the push-out products and trading revenue from interest rate and FX products.<sup>13</sup>

Netting sets are counterparty-specific and allow banks to offset derivative contracts with a positive value against those with a negative value, resulting in a two-fold effect: (1) reduced operational burden, and (2) reduced credit exposure. Operational burdens decline because there will be fewer margin calls and associated payments, as there would not be a need to bifurcate the portfolio for daily margining. Credit exposure declines because of portfolio effects. The more trades in a netting set, especially when those trades involve multiple market factors (e.g., interest rates, equity, commodity, etc.), the more likely it is that trades will offset each other, leading to a lower amount of credit exposure. Pushing out a subset of trades – commodity, equity, and credit derivatives – would split the netting set and would likely result in increased credit exposures due to the loss of portfolio effects.

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<sup>13</sup> Since 2010, the correlation of trading revenue from the push-out products against trading revenue from interest rate and FX products is negative 7 percent. We used the period since 2010 to avoid the distortive effects of the financial crisis, and to ensure consistent reporting of revenue, as credit trading revenue did not become available until 2007.



**Q11: Any assessments conducted by your agency regarding the risks to the U.S. economy created by the partial repeal of Section 716.**

**A:** The OCC has not made any assessments regarding the risks to the U.S. economy resulting from the partial repeal of section 716.

Finally, you asked us to provide our views on how the partial repeal of section 716 will affect the implementation of new margin rules for dealers of non-cleared swaps and security-based swaps and sections 23A and 23B of the Federal Reserve Act. These margin rules arise from sections 731 and 764 of the Dodd-Frank Act, as amended by the Terrorism Risk Insurance Reauthorization Act of 2015. The OCC, together with the Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), the Farm Credit Administration (FCA), and the Federal Housing Finance Agency (FHFA), is responsible for issuing these margin rules for the firms under our respective jurisdictions.

Pursuant to sections 731 and 764 of the Dodd-Frank Act, these margin rules apply to swap dealers and major swap participants registered with the Commodity Futures Trading Commission (CFTC) and security-based swap dealers and major security-based swap participants registered with the Securities and Exchange Commission (SEC).<sup>14</sup> In addition to covering the institutions within the jurisdictions of the agencies mentioned above, sections 731 and 764 direct the CFTC and SEC to issue comparable margin rules for the other dealers within their respective jurisdictions. As a result, any section 716 “swaps entity” within a bank holding company will be subject to comparable regulations requiring them to exchange margin with their non-cleared swap customers.<sup>15</sup> In the same vein, a customer seeking to transact non-cleared swaps with a bank holding company dealer will exchange margin on a comparable basis regardless of which swaps entity the customer faces.

In addition, the proposed margin rule published by the OCC, FRB, FDIC, FCA, and FHFA in September 2014, would require bank swap dealers to exchange margin on swaps and security-based swaps transacted between the dealer and its affiliates. In the proposal, the agencies stated that they viewed the proposal as being consistent with the “comparable terms” element of section 23B to which you refer in your letter. The agencies currently are working to develop a final rule.

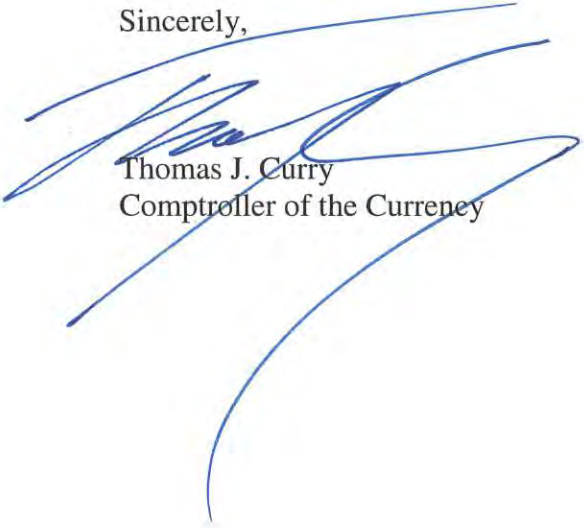
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<sup>14</sup> Section 716 applies to a “swaps entity,” which is defined in that section to mean the same group of registered dealers and major participants.

<sup>15</sup> According to the CFTC, this practice is already in place in several U.S. bank holding companies, under which a bank subsidiary is registered as a swap dealer and other non-bank subsidiaries of the holding company are also registered as swap dealers. For a list of provisionally-registered swap dealers, please refer to: <http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer>.

I trust this information is responsive to your inquiry. If you have any questions, please do not hesitate to contact me or Carrie Moore, Director, Congressional Liaison, at (202) 649-6737.

Sincerely,



Thomas J. Curry  
Comptroller of the Currency