BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 9, 2015

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

The Honorable Elijah E. Cummings
House of Representatives
Washington, D.C. 20515

Dear Senator and Congressman:

This is in response to your letter of July 16, 2015, regarding section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 716 generally prohibits the provision of Federal assistance to any swaps entity with regard to any swap, security-based swap, or other activity of the swaps entity.[1]

As originally enacted, section 716 provided that its prohibition did not apply to any insured depository institution that is a major swap participant or security-based swap participant. Section 716 also originally did not apply to any insured depository institution that is a swap dealer or security-based swap dealer so long as the insured depository institution limited its derivatives activities to (1) certain hedging activities and similar risk mitigation activities, and (2) swaps involving rates or reference assets permissible for investment by a national bank (other than credit default swaps that are not centrally cleared). Finally, section 716 specifically provided that the prohibitions in that section did not apply to an affiliate of an insured depository institution so long as the insured depository institution is part of a bank holding company and the affiliate complies with the inter-affiliate requirements of sections 23A and 23B of the Federal Reserve Act.

In December 2014, Congress amended section 716 to change the scope of this provision. Under section 716 as amended, insured depository institutions and U.S. branches and agencies of foreign banks were treated the same.

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[1] The term "swaps entity" generally includes any swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant that is registered under the Commodity Exchange Act or the Securities Exchange Act of 1934, as applicable. *See* Section 716(d) of the Dodd-Frank Act; 15 U.S.C. 8305(d).

The amendments also exempted insured depository institutions that are swap dealers or security-based swap dealers (covered depository institutions) that engage in (1) certain hedging activities or similar risk mitigation activities; (2) swaps or security-based swaps other than structured finance swaps; and (3) structured finance swaps for hedging or risk management purposes. A "structured finance swap" is defined by section 716 as a swap or security-based swap based on an asset-backed security (or group or index primarily comprised of asset-backed securities).[2]

You asked for estimates of the value of swaps that would have been required to be pushed out of insured depository institutions before and after the amendment to section 716. Prior to the amendment, insured depository institutions were permitted to continue to engage in interest rate swaps, foreign exchange swaps, and swaps on bank-permissible assets. Insured depository institutions would have been required to push out to an affiliate swaps on equities, swaps on commodities, and uncleared credit default swaps unless these swaps were used for hedging or otherwise mitigating risk directly related to the activities of the insured depository institution. As you note, section 716 as amended permits a covered depository institution to engage in swaps that do not qualify as structured finance swaps. The Federal Reserve tracks the aggregate notional derivatives exposure of banks (other than savings associations). Appendix A sets forth that information for the period from 2005-2015. As shown in Appendix A, the substantial majority of the swaps engaged in by banks are interest rate and foreign exchange swaps. Accordingly, swaps that would have been required to be pushed out before amendments to section 716 would have comprised a modest amount of overall bank swap activity as measured by notional value.

Section 716 as amended permits covered depository institutions to engage in structured finance swaps that are undertaken for hedging or risk management purposes, but it does not define the term "hedging and risk management purposes." Through the supervisory process, the Federal Reserve intends to ensure that covered depository institutions under Federal Reserve supervision limit their swap and security-based swap activities to those permissible under section 716. In particular, the Federal Reserve engages in ongoing and broad supervision of bank risk management practices including hedging activities and practices. For example, examiners are instructed to review an institution's use of various instruments (such as derivatives) for risk-management purposes. When instruments are used for risk-management purposes, the hedging rationale and performance criteria are expected to be well documented.[3] A bank's risk management and hedging activities will depend on the specific nature of the risks being hedged. The Federal Reserve expects the bank to be able to explain how structured

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[2] Section 716(d)(2)(A) of the Dodd-Frank Act; 15 U.S.C. 8305(d)(2)(A).

[3] See Trading and Capital-Markets Activities Manual. www.federalreserve.gov/boarddocs/supmanual/trading/trading.pdf.

finance swaps that are conducted for hedging purposes will reduce risk and are related to specific risk factors that have been identified by the bank. The Federal Reserve will carefully consider, within the context of the overall supervisory process, whether a bank's use of structured finance swaps is consistent with prudent risk management and hedging practices. Further, because section 716 applies to insured depository institutions supervised by the other federal banking agencies, as well those supervised by the Federal Reserve, we will consult with those agencies on the administration of section 716.

We also note that section 619 of the Dodd-Frank Act, also known as the Volcker Rule, applies to all banking entities (including all insured depository institutions and their affiliates) and generally prohibits any banking entity from proprietary trading. To the extent that transactions involving swaps constitute proprietary trading under the Volcker Rule, a banking entity (including its affiliates) must meet an exemption under the final rule to engage in those swaps transactions. The amendments to section 716 did not change the applicability or scope of the limitations in section 619. An insured depository institution (including its affiliates) that relies on the hedging exemption to the Volcker Rule must, among other things, document that the hedging activity mitigates specific and identifiable risks in connection with identified individual or aggregated positions of the banking entity; demonstrably reduces or otherwise significantly mitigates risk; is continuously reviewed and adjusted to ensure risks continue to be demonstrably reduced; is conducted in accordance with a written compliance program; is subject to position and aging limits; is supported by analysis of the strategies, techniques, and positions permitted for risk-mitigating hedging; and is subject to internal controls and audit, among other things.[4]

You have also requested copies of applications that the Federal Reserve received requesting a transition period under section 716. Of the banks discussed in your letter, the Federal Reserve is the primary federal banking supervisor for only Goldman Sachs Bank. Attached, please find the transition period request filed by Goldman Sachs Bank and its supplemental submission, which have been redacted to remove confidential proprietary information protected from disclosure by the provisions of the Trade Secrets Act.

In your letter, you requested any assessment conducted by the Federal Reserve regarding the "operational and credit risks" that the implementation of section 716 would have created for U.S. banks. Section 716 directs the appropriate federal banking agency to permit an insured depository institution up to 24 months to divest or cease its covered

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[4] 12 CFR 248.5.

swap activities (subject to further extension up to one year).[5] In determining the length of this transition period, the appropriate federal banking agency must take into account the potential impact of the divestiture or cessation of swaps activities on the insured depository institution's (1) mortgage lending, (2) small business lending, (3) job creation, and (4) capital formation versus the potential negative impact on insured depositors and the Deposit Insurance Fund.[6] Section 716 provides that the appropriate Federal banking agency may also consider other factors as may be appropriate.[7] In its review of transition period requests, in addition to the listed statutory factors, the Federal Reserve considered potential operational risks. For example, the Federal Reserve found that near-term cessation or divestiture of a company's swaps activities may increase operational risks problems, and that operational problems in swaps markets could easily disrupt broad financial markets because swaps are widely used by corporations, institutional investors, and other financial market participants.[8]

In addition, you asked for information regarding assessments conducted by the Federal Reserve regarding the effects of the amendment of section 716. The amendment of section 716 was a decision made by the Congress and the President. The Federal Reserve did not undertake an assessment of the effect of an amendment to section 716 compared to the originally enacted section nor did we conduct an assessment of the impact of the amendment of section 716 on bank behavior in the swaps market, risks to the U.S. economy, or other matters.

We would note, however, that the Federal Reserve and the other federal banking agencies exercise a variety of authorities to monitor and address the derivatives activities of banking organizations. In particular, the Federal Reserve monitors the derivative activities of banking organizations through the ongoing supervisory process. The Federal Reserve also addresses the risks of derivatives activities through regulatory requirements. For instance, the Federal Reserve significantly strengthened the regulatory capital requirements for derivatives activities of banking organizations following the financial crisis. In addition, recently finalized liquidity rules for banking organizations help address the liquidity risks posed by derivative exposures.[9] Moreover, as noted above, derivatives activities are subject to limitations imposed by the Volcker Rule and will be subject to additional restrictions through implementation of the single counterparty credit limits of section 165(e) of the Dodd-Frank Act and the margin rule for non-cleared swaps, discussed further below.

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[5] Section 716(j) of the Dodd-Frank Act; 15 U.S.C. § 8305(j).

[6] Id.

[7] Id.

[8] See Letter dated July 2, 2013, from the Federal Reserve to Ms. Esta E. Stecher, Goldman Sachs Bank USA; Letter dated July 9, 2013, see also from the Federal Reserve to Vijay K. Suchdev. Esq., Senior Managing Counsel, Bank of New York Mellon.

[9] 79 Fed. Reg. 61440 (Oct. 10, 2014).

You have also asked about the effect of the amendment of section 716 on the implementation of sections 23A and B of the Federal Reserve Act and on the forthcoming margin rule for non-cleared swaps. We do not believe that the amendment of section 716 will have an impact on the implementation of section 23A or B of the Federal Reserve Act. Sections 23A and B impose quantitative and qualitative limits on transactions between an insured depository institution and its affiliates.[10] Sections 608 and 609 of the Dodd-Frank Act amended sections 23A and B to include derivatives in the list of transactions subject to the limitations contained in those sections. While section 716 as amended changed the scope of swaps that could continue to be conducted in the insured depository institution, it did not change the application of sections 23A and B to derivative transactions between an insured depository institution and its affiliates.

Similarly, although section 716, as amended, changed the scope of non-cleared swaps that could continue to be conducted in insured depository institutions, the amendment of section 716 did not change the margin and capital rule provisions of Title VII of the Dodd-Frank Act.[11]

The Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration (together, the prudential regulators) issued a joint proposal last year to implement the Dodd-Frank Act's requirements for margin on swaps by swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (swap entities) for which those agencies are the prudential regulators.[12] That rule would establish initial and variation margin requirements for swaps and security-based swaps that are not centrally cleared (non-cleared swaps). The comment period has since ended, and the prudential regulators are working to finalize the rule.

The margin rule would apply to all non-cleared swaps conducted by prudentially regulated bank swap entities, including those that would have been subject to the provisions of section 716. In the proposed rule, the prudential regulators proposed to apply the margin requirements to swaps between banks that are swap entities and their affiliates. We received a number of comments raising issues regarding the treatment of inter-affiliate swaps. In particular, commenters argued that requiring initial margin on inter-affiliate swaps could discourage efficient risk management, increase group-wide third-party credit risk, reduce liquidity, and undermine the exemption from clearing for such swaps. We are currently considering all comments received on the proposal as we work with the other prudential regulators to finalize the rule.

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[10] 12 U.S.C. § 371c; 12 U.S.C. §371c-1.
[11] 7 U.S.C. § 6s; 15 U.S.C. § 78o-10.
[12] 79 Fed. Reg. 57348 (Sept. 24, 2014).

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In your letter, you state that banks will have an incentive to meet collateral requirements in the least expensive way possible and will "push in" more derivatives transactions to federally insured institutions to reduce costs. The agencies are carefully considering this concern and the others raised in your letter, as well as the potential risks and incentives created by their rules as we develop a final rule governing swap margin requirements.

I hope you find this information helpful.

Sincerely,

Janet L. Yellen

Enclosures

Appendix A

Table of derivative notionals for product categories 2005-2015

Derivative Notionals at Year End for All Insured Commercial Banks: 2005 - March 2015 ($, billions)											
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	March 2015
Interest Rate	84,517	107,421	129,880	175,880	181,439	193,382	187,845	178,846	194,509	173,877	157,660
Foreign Exchange	9,719	12,564	17,174	16,923	17,300	22,003	26,499	28,630	29,672	34,744	35,562
Credit	5,822	9,020	15,863	16,029	14,112	14,151	14,759	13,190	11,257	9,448	9,016
Equity	1,255	2,271	2,524	2,207	1,685	1,364	1,606	1,970	2,077	2,577	2,359
Commodity and Other	552	893	1,067	1,061	979	1,195	1,330	1,396	1,204	1,210	1,233