# Joint Press Release

June 25, 2020

## Statement by Governor Brainard

I support the proposed changes permitting certain amendments to legacy swaps, initial phase-in dates, and documentation requirements. I do not support the elimination of the requirement that banks collect initial margin from their affiliates because it could again leave banks exposed to the buildup of risky derivatives, which proved to be a significant risk in the financial crisis.

In the aftermath of the global financial crisis, the Dodd-Frank Act mandated financial reforms that required banks to improve their management of risks significantly. Financial reforms have enabled banks to play a constructive role in responding to the COVID-19 crisis, and it is a mistake to weaken them when they are clearly proving their value in the first serious test since the global financial crisis.

During the financial crisis, the buildup of large, uncleared swap positions without prudent margining practices exposed banks and other covered swap entities to losses and put the broader financial system at risk. In response, the Dodd-Frank Act included special provisions for uncleared swaps as a critical prudential protection.

The federal banking agencies adopted a final swap margin rule in 2015 that requires prudent margining practices in order to protect the safety and soundness of banks in the event of a counterparty default and guard against broader risks to financial stability. The rule recognizes that banks' derivatives transactions with affiliated parties, such as foreign affiliates and nonbank affiliates, pose important risks and represent a large share of uncleared swaps activity. The rule requires banks to collect but not post initial margin in swaps with affiliated counterparties. This special provision recognizes that swaps with affiliated counterparties pose important risks to the depository institution and that these risks may be different than those associated with swaps with unaffiliated counterparties.

Today's rule effectively eliminates the requirement that a bank that is a dealer in derivatives collect initial margin from its affiliates. It does so on the basis of "supervisory experience" since the final rule was implemented in 2015. I supported the 2015 final rule, and I have not been presented with compelling analysis that would warrant eliminating this important safeguard.

Although today's final rule includes a requirement that a bank collect initial margin from an affiliate if the bank's aggregate amount of calculated inter-affiliate initial margin exposure exceeds 15 percent of its tier 1 capital, this threshold has little practical impact, as no U.S.

bank comes close to it. A bank likely would only approach this threshold through an increase in the volume of uncleared swaps with affiliates or a depletion of tier 1 capital. Under such circumstances, however, it could well be too late to start implementing prudent risk-reducing margin requirements. Overall, the 15 percent of tier 1 threshold would permit the largest U.S. banks to accumulate more than $110 billion of potential future exposure to their affiliates without any collateral protection.

Finally, I was surprised to see that the preamble to the final rule announces a new Federal Reserve Board interpretive position that banks generally would not have to collect initial margin from affiliates on swaps under section 23A of the Federal Reserve Act. The new preamble further asserts that, in many cases, banks would not need to collect initial margin from affiliates under the market terms requirement of section 23B. This would generally preclude sections 23A and 23B of the Federal Reserve Act from providing necessary protections to the depository institution. This is a significant change from the language in the preamble of the proposed rulemaking, which noted that "certain affiliate transactions are subject to the requirements of sections 23A and 23B of the Federal Reserve Act as implemented by the Federal Reserve's Regulation W" and asserted that these "are the more effective tools to address risks arising from transactions between affiliates."

The Dodd-Frank amendments to section 23A expressly include in the definition of covered transaction any derivative transaction between a bank and an affiliate "to the extent that the transaction causes the bank . . . to have credit exposure to the affiliate." Section 23A requires any credit exposure of a bank to an affiliate on a derivative transaction to be "secured at all times." Although section 23A does not specify how a bank must measure the covered transaction amount, the Board has the authority to require a bank to value a bank-affiliate derivative as the sum of the bank's current exposure plus potential future credit exposures, and this approach would be in keeping with the Board's conventional transaction valuation practices under Regulation W. Regulation W generally covers potential future credit exposure in transactions between a bank and an affiliate, and this is also the approach to the valuation of derivatives in the Board's risk-based capital, supplementary leverage ratio, and single-counterparty credit limit rules.

Section 23B and Regulation W generally require the terms and circumstances for transactions between a bank and its affiliate to be at least as favorable to the bank as those prevailing at the time for comparable transactions with third parties. Comparable derivative transactions between a bank and a third party require the bank to collect and post initial margin. So it is contrary to the spirit of Regulation W for a bank to collect no initial margin for a derivative transaction with an affiliated counterparty when it would be required both to collect and post initial margin for a comparable swap with a third party.

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