FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

SHEILA C. BAIR
CHAIRMAN

April 30, 2010

Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Honorable Blanche L. Lincoln
Chairman
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Chairman Dodd and Chairman Lincoln:

Thank you for reaching out to the Federal Deposit Insurance Corporation for our views on Title VII of the "Wall Street Transparency and Accountability Act" contained in S. 3217, the "Restoring American Financial Stability Act of 2010." At the outset, I would like to express my strong support for enhanced regulation of "over-the-counter" (OTC) derivatives and the provisions of the bill which would require centralized clearing and exchange trading of standardized products. If this requirement is applied rigorously it will mean that most OTC contracts will be centrally cleared, a desirable improvement from the bilateral clearing processes used now. I would also like to express my wholehearted endorsement of the ultimate intent of the bill, to protect the deposit insurance fund from high risk behavior.

I would like to share some concerns with respect to section 716 of S. 3217, which would require most derivatives activities to be conducted outside of banks and bank holding companies. If enacted, this provision would require that some $294 trillion in notional amount of derivatives be moved outside of banks or from bank holding companies that own insured depository institutions, presumably to nonbank financial firms such as hedge funds and futures commission merchants, or to foreign banking organizations beyond the reach of federal regulation. I would note that credit derivatives – the riskiest – held by banks and bank holding companies (when measured by notional amount) total $25.5 trillion, or slightly less than nine percent of the total derivatives held by these entities.

At the same time, it needs to be pointed out that the vast majority of banks that use OTC derivatives confine their activity to hedging interest rate risk with straightforward interest rate derivatives. Given the continuing uncertainty surrounding future movements in interest rates and the detrimental effects that these could have on unhedged banks, I encourage you to adopt an approach that would allow banks to easily hedge with OTC derivatives. Moreover, I believe that directing standardized OTC products toward exchanges or other central clearing facilities would accomplish the stabilization of the OTC market that we seek to enhance, and would still allow banks to continue the important market-making functions that they currently perform.

In addition, I urge you to carefully consider the underlying premise of this provision - that the best way to protect the deposit insurance fund is to push higher risk activities into the so-called shadow sector. To be sure, there are certain activities, such as speculative derivatives trading, that should have no place in banks or bank holding companies. We believe the Volcker rule addresses that issue and indeed would be happy to work with you on a total ban on speculative trading, at least in the CDS market. At the same time, other types of derivatives such as customized interest rate swaps and even some CDS do have legitimate and important functions as risk management tools, and insured banks play an essential role in providing market-making functions for these products

Banks are not perfect, but we do believe that insured banks as a whole performed better during this crisis because they are subject to higher capital requirements in both the amount and quality of capital. Insured banks also are subject to ongoing prudential supervision by their primary banking regulators, as well as a second pair of eyes through the FDIC's back up supervisory role, which we are strengthening as a lesson of the crisis. If all derivatives market-making activities were moved outside of bank holding companies, most of the activity would no doubt continue, but in less regulated and more highly leveraged venues. Even pushing the activity into a bank holding company affiliate would reduce the amount and quality of capital required to be held against this activity. It would also be beyond the scrutiny of the FDIC because we do not have the same comprehensive backup authority over the affiliates of banks as we do with the banks themselves. Such affiliates would have to rely on less stable sources of liquidity, which – as we saw during the past crisis – would be destabilizing to the banking organization in times of financial distress, which in turn would put additional pressure on the insured bank to provide stability. By concentrating the activity in an affiliate of the insured bank, we could end up with less and lower quality capital, less information and oversight for the FDIC, and potentially less support for the insured bank in a time of crisis. Thus, one unintended outcome of this provision would be weakened, not strengthened, protection of the insured bank and the Deposit Insurance Fund, which I know is not the result any of us want

A central lesson of this crisis is that it is difficult to insulate insured banks from risk taking conducted by their nonbanking affiliated entities. When the crisis hit, the shadow sector collapsed, leaving insured banks as the only source of stability. Far from serving as a source of strength, bank holding companies and their affiliates had to draw stability from their insured deposit franchises. We must be careful not to reduce even further the availability of support to insured banks from their holding companies. As a result, we believe policies going forward should recognize the damage regulatory arbitrage caused our economy and craft policies that focus on the quality and strength of regulation as opposed to the business model used to support it.

The FDIC is pleased to continue working with you on this important issue to assure that the final outcome serves all of our goals for a safer and more stable financial sector. We hope that a compromise can be achieved by perhaps moving some derivatives activity into affiliates, so long as capital standards remain as strict as they are for insured depositories and banks continue to be able to fully utilize derivatives for appropriate hedging activities.

Please do not hesitate to contact me at 202-898-6974 or have your staff contact Paul Nash, Deputy Director for External Affairs, at 202-898-6962.

Sincerely,

Sheila C Bair

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