From: Quach, Anh <Anh.Quach@capitalone.com>
Sent: Monday, September 20, 2010 3:21 PM
To: dfadefinitions <dfadefinitions@CFTC.gov>; rule-comments@sec.gov
Cc: regs.comments@occ.treas.gov; regs.comments@federalreserve.gov
Subject: Capital One Comment on CFTC & SEC "Definitions" ANPR [Release No. 34-62717; File No. S7-16-10]
Attach: Capital One Comment on Definitions [File No. S7-16-10] (September 20 2010).pdf

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Please find attached Capital One's comment on CFTC and SEC advance notice of proposed rulemaking on *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act*.

If you have any technical difficulties with this document please feel free to contact me.

Sincerely,
Anh

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Capital One Financial Corporation
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September 20, 2010

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dfadefinitions@cftc.gov

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
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Re: Comments on the Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (CFTC Definitions; SEC File Number S7-16-10)

Dear Mr. Stawick and Ms. Murphy:

Capital One Financial Corporation (together with its subsidiaries, "Capital One")[1] submits this letter in response to the Advance Joint Notice of Proposed Rulemaking issued by the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") on key definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2] Capital One appreciates the opportunity to comment on these important definitions at this early stage in the regulatory rulemaking process.[3]

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[1] Capital One Financial Corporation (http://www.capitalone.com) is a financial holding company whose subsidiaries, which include Capital One, N.A. and Capital One Bank (USA), N. A., had $117.3 billion in deposits and $197.5 billion in total managed assets outstanding as of June 30, 2010. Headquartered in McLean, Virginia, Capital One offers a broad spectrum of financial products and services to consumers, small businesses and commercial clients. Capital One, N.A. has approximately 1,000 branch locations primarily in New York, New Jersey, Texas, Louisiana, Maryland, Virginia, and the District of Columbia. A Fortune 500 company, Capital One trades on the New York Stock Exchange under the symbol "COF" and is included in the S&P 100 index.

[2] *See* 75 Fed. Reg. 51429 (August 20, 2010).

[3] We also are providing these comments to the SEC in connection with its rulemaking relating to the definition of "Major Security-Based Swap Participant" given that this definition is to be coordinated with the CFTC's rulemaking relating to the definition of "Major Swap Participant".

Introduction

Capital One supports efforts to provide greater transparency to the over-the-counter ("OTC") derivatives market and to monitor dealers and significant market participants whose derivative activities may pose systemic risk to the U.S. financial system. Capital One also support efforts to implement clearing and exchange trading requirements for all financial entities whose swaps are accepted for clearing or exchange trading, including those who are financial end-users of derivatives such as Capital One and regardless of the purpose of the swap transaction.

Capital One enters into swaps with large bank swap dealers to help mitigate the risks of its ordinary banking activities, such as hedging the interest rate and currency risks arising from its core lending and deposit-taking activities. While Capital One does not buy and sell swaps as a primary part of its business, it offers to enter into a swap with its commercial and small business banking customers in connection with originating a loan with these customers. Capital One manages the interest rate risk exposure arising from each customer-facing swap by entering into offsetting interest rate swaps with large swap dealers.

Capital One's swap activities are essentially those of a financial end-user. Banks such as Capital One are considered "financial entities" under Section 723 of the Dodd-Frank Act. Capital One therefore is not eligible for the end-user clearing exemption and instead subject to mandatory clearing and exchange trading for all of its swaps that are accepted for clearing and exchange trading. Also, like all banks, Capital One's swap activities are subject to strong prudential federal supervision and regulation, including capital regulations, which specifically address the risks of banks' derivatives activities.

Capital One is concerned, however, that through the regulatory rulemaking process banks that are financial end-users of derivatives could be inadvertently designated "Major Swap Participants" under the Dodd-Frank Act. For main street lending banks such as Capital One, the additional regulatory burdens from being designated a "Major Swap Participant" would increase the costs of ordinary course banking activities, such as hedging against interest rate or foreign exchange exposures or in connection with lending to small business and other commercial customers. Capital One also is concerned that classifying financial end-users as "Major Swap Participants" will sharply reduce credit and liquidity at a time when both remain limited as the economy slowly recovers. Capital One encourages the CFTC to clarify the definition of "Major Swap Participant" so that it excludes those financial end-users whose swaps positions are largely non-complex, highly liquid interest rate and foreign exchange swaps arising from their normal banking activities.[4]

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[4] Given the nature of embedded customer options in traditional deposit and lending products such as mortgages, banks also use plain vanilla derivatives such as caps, floors and swaptions to hedge their interest rate risk exposure.

The Dodd-Frank Act defines "Major Swap Participant" as any person other than a swap dealer (i) that maintains a "Substantial Position" in swaps, excluding positions held for hedging or mitigating "Commercial Risk", (ii) whose outstanding swaps create "Substantial Counterparty Exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets or (iii) is a highly leveraged financial entity not subject to capital requirements established by an appropriate Federal banking agency and which maintains a "Substantial Position" in swaps in any major swap category as determined by the CFTC.

The CFTC's clarification on what is considered a "Substantial Position" in swaps, whether "Commercial Risk" includes interest rate and foreign exchange exposures, and what swap positions create "Substantial Counterparty Exposure" is critical for financial end-users and other market participants. Only with such clarification will entities be able to determine how their swaps activities fit in the framework of derivatives regulation. Capital One shares below its concerns about these terms in the definition of "Major Swap Participant", which if applied broadly to swap market participants including financial end-users, would do very little to contain systemic risk yet would pull liquidity and credit out of the economy in the early stages of recovery.

The term "Substantial Position" in the definition of "Major Swap Participant" should be defined to capture a limited group of non-dealer entities whose activities could pose systemic risk

Consideration of Swap Category or Type of Activity. In determining whether an entity maintains a "Substantial Position" in swaps, Capital One asks the CFTC to consider the entity's relative position in complex, riskier derivatives as compared to standard, liquid derivatives such as interest rate swaps used for risk management and hedging purposes.

Credit default swaps, for example, played an instrumental role in the recent financial crisis. While credit default swaps have characteristics that are similar to other OTC derivatives, it is widely acknowledged that they also have characteristics that distinguish them from other types of derivatives.[5] Credit default swaps function essentially as binary options where a seller of credit default swaps collecting a steady stream of monthly premium could suddenly face massive losses if the referenced entity defaults. Such a "jump-to-default" payout structure of credit default swaps creates many challenges in managing risk exposure as compared, for example, to interest rate derivatives used for risk management purposes that adjust continuously based on the movements of the underlying rate.[6]

[5] *See, e.g.*, Keynote Address of Chairman Gary Gensler, OTC Derivatives Reform, Markit's Outlook for OTC Derivatives Markets Conference (March 9, 2010). Available at (http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-32.html).

[6] *Id.*

The new comprehensive regulatory framework for OTC derivatives should be implemented in a manner that (i) recognizes the unique characteristics of different types of derivatives (e.g., interest rate swaps, foreign exchange swaps, equity swaps and credit default swaps) and (ii) considers the likelihood for certain swap categories to create systemic risk such as credit default swaps used for speculative purposes as compared to standard derivatives such as interest rate risk swaps used for risk management purposes.

Consideration of Market Positioning. Other than Section 716's prohibition against federal assistance for swaps entities, the extensive requirements under the Dodd-Frank Act for both "Swap Dealers" and "Major Swap Participants" are nearly identical.[7] Capital One believes the "Major Swap Participant" definition should capture only those very active market participants, whose significant swap positions pose systemic risk yet do not fall squarely in the definition of "Swap Dealer". Financial end-users who enter into swaps with a small group of large bank swap dealers for risk management purposes do not pose systemic risk from their swap activities. It does not seem consistent with legislative intent to further define "Major Swap Participant" in manner where financial end-users designated as "Major Swap Participants" face the same extensive regulatory requirements applicable to large commercial banks who buy and sell swaps as 'Swap Dealers". Applying extensive regulatory requirements to such financial end-users would impose costs on banks and their customers that would far outweigh the risk posed to the stability of the U.S. banking system from such ordinary course swap activities.

A comprehensive framework of derivatives regulation is appropriate for an entity that is centrally positioned in the market for hundreds, if not thousands, of counterparties. However, such framework does not fit the risk profile and counterparty exposures arising from the overwhelming majority of banks executing swaps for risk management and hedging purposes with a small number of systemically-important bank swap dealers. Importantly, reform efforts would not be circumvented as Title VII of the Dodd-Frank Act requires financial entities such as Capital One to follow mandatory clearing requirements to reduce market risk and report trade information to promote public transparency of the derivatives market.

In fact, the Office of the Comptroller of the Currency ("OCC") noted in its Q1 2010 report on Bank Trading and Derivatives Activities that just five large commercial banks represented 97% of the total banking industry notional amounts and 86% of industry net counterparty credit exposure.[8] While Capital One is among those banks deemed systemically significant under the Dodd-Frank Act based solely on its asset size, the OCC's report unequivocally demonstrates that only "five banks dominate in derivatives" relative to all commercial banks.[9] Capital One asks the CFTC to define the term "Substantial Position" in the "Major Swap Participant" definition with a focus on (i)

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[7] See Section 731 of Title VII of the Dodd-Frank Act.

[8] OCC's Quarterly Report on Bank Trading and Derivatives Activities First Quarter 2010. Available at (http://www.occ.treas.gov/ftp/release/2010-71a.pdf).

[9] *Id.*

the purpose of the swap activity (i.e., risk management vs. trading/speculation), (ii) the category of swap (e.g., interest rate risk or foreign exchange vs. credit derivative) and (iii) the relative net position within a swap category. By using these factors, the CFTC may differentiate between those entities requiring extensive regulation because their swaps activities are a primary part of their business and swap positions pose systemic risk and those financial and other end-users whose use of swaps for risk management purposes require less extensive regulation.

The definition of "Commercial Risk" should include balance sheet risk from interest rate and foreign exchange exposures

Title VII of the Dodd-Frank Act, both in the definition of which entities are "Major Swap Participants" and in the end-user exemption from clearing requirements, provides advantageous treatment for swaps used to mitigate or hedge "Commercial Risk". Capital One encourages the CFTC to define "Commercial Risk" to include balance sheet exposures from interest rate and foreign exchange fluctuations. Capital One is concerned that if these exposures are not included in "Commercial Risk", financial and other end-users hedging interest rate or foreign exchange exposures could be unintentionally categorized as "Major Swap Participants".

Notably, Congress excluded from the "Major Swap Participant" definition any entity whose primary business is providing financing, and which uses derivatives for the purpose of hedging underlying *commercial risks related to interest rate and foreign currency exposures*, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.[10] In this so-called "captive finance company" exclusion, Congress specifically referenced interest rate and foreign exchange exposures as examples of "Commercial Risk". Just as Congress recognized the commercial risks arising from interest rate and foreign exchange exposure, Capital One encourages the CFTC to define "Commercial Risk" in the "Major Swap Participant" definition to similarly include the hedging of interest rate or foreign exchange exposures.

The definition of "Substantial Counterparty Exposure" in the definition of "Major Swap Participant" should capture the limited group of non-dealer entities whose swap positions actually could pose systemic risk

Capital One believes the exposure of the financial system to a single entity's failure is best measured by the aggregate amount of such entity's net derivatives payables.[11] Derivatives payables represent the total of all swaps having a negative value

[10] See Section 721(a)(2) 33 (D) of Title VII of the Dodd-Frank Act.

[11] *See* Manmohan Singh, "Collateral, Netting and Systemic Risk in OTC Derivatives Market," International Monetary Fund Working Paper 10/ 99 (2010). Available at (http://www.imf.org/external/pubs/ft/wp/2010/wp1099.pdf). *See also* Bank for International Settlements,

to an entity and measures the loss exposure such entity poses to its counterparties. As a more precise measure of a swap participant's counterparty exposure, the CFTC should allow swap participants to calculate their derivatives payables by reducing the gross amount by (i) the value of any high quality and liquid collateral held against such loss exposure and (ii) any offset amount from netting its swaps contracts with positive values against those contracts with negative values where there is a netting agreement in place with the counterparty.[12]

In determining "Substantial Counterparty Exposure", the CFTC also should consider the extent to which an entity's exposure to counterparties is collateralized by such entity. Capital One believes the most important factor for the CFTC to use in determining whether an entity's swap positions create "Substantial Counterparty Exposure" is the amount of uncollateralized counterparty exposure to such entity. As the amount of uncollateralized counterparty exposure increases, the amount of loss exposure also grows thereby increasing the probability that an entity's default will pose systemic risk. Cleared swaps that are fully collateralized, however, should not be included in the calculation of substantial counterparty exposure because the actual risk of loss for cleared swaps in most cases should be offset by an entity's margin amount.[13]

The OCC's Quarterly Report on Bank Trading and Derivatives Activities states that banks held collateral against 67% of derivatives payables (net of derivatives receivables) at the end of Q1 2010.[14] When examining the report more closely, the data reveals essentially two distinct swaps markets – a bank-to-bank market and also a large bank swap dealer to corporate end-user market. In the bank-to-bank market, banks held collateral against 97% of their exposure to other banks and securities firms, while the collateral coverage of banks in the large bank swap dealer to corporate end-user market dropped dramatically to 27% and 0% against corporate and monoline financial firm exposure, respectively.

Capital One believes such divergence in margin practices for these two swap markets should inform the CFTC' rulemaking on the definition of "Substantial Counterparty Exposure". Specifically, a swaps portfolio consisting of predominantly bank-to-bank swaps should, in the overwhelming majority of instances, not pose systemic risk. It would follow then the costly government intervention to contain the systemic risk

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Monetary and Economic Department, OTC Derivatives Market Activity in the Second Half of 2009 (May 2010). Available at (http://www.bis.org/publ/otc_hy1005.pdf?noframes=1). *See also* OCC's Quarterly Report on Bank Trading and Derivatives Activities First Quarter 2010 (2010). Available at (http://www.occ.treas.gov/ftp/release/2010-71a.pdf).

[12] *Id.*

[13] Another consideration is the ability of the financial system to absorb the positions of a failed counterparty so that the risk of loss associated with the failed counterparty's outstanding positions does not severally disrupt the derivatives market and financial system.

[14] OCC's Quarterly Report on Bank Trading and Derivatives Activities First Quarter 2010. Available at (http://www.occ.treas.gov/ftp/release/2010-71a.pdf).

from a large corporate user of derivatives such as AIG may have been averted had large bank swap dealers required AIG at the outset to satisfy margin requirements against its substantial swap positions.

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Capital One supports the regulatory reform efforts to implement clearing requirements for all financial entities. It is very important, however, for the CFTC to define "Major Swap Participant" in a manner that reflects the degree of risk of loss, swap category differences and the financial end-user status of most banks. Financial end-users who enter into swaps with a small group of large bank swap dealers for risk management purposes, rather than for trading, simply do not pose systemic risk from their swap activities. Applying onerous regulatory requirements from the "Major Swap Participant" category to such financial end-users will increase costs for banks and their customers, reduce liquidity and threaten the economic recovery.

Capital One again appreciates the opportunity to comment on these key definitions at this early stage of the regulatory rulemaking process and welcomes the opportunity to discuss any questions you may have on our comments. Feel free to contact me on (703) 720-1000.

Sincerely,

Stephen Linehan
Executive Vice President and Treasurer

cc: Federal Reserve Board of Governors

Office of the Comptroller of the Currency