



Occupy the SEC

<http://www.occupythesec.org>

January 20, 2014

House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Re: The Dangers Presented by H.R. 3819 - Fairness for Community Job Creators Act

Dear Sirs and Mesdames:

Occupy the SEC¹ submits this letter for review by the House Committee on Financial Services (“Committee”), in connection with its consideration of H.R. 3819, the Fairness for Community Job Creators Act. H.R. 3819 amends Section 619 of the Dodd-Frank Act, better known as the Volcker Rule. Under the amendment, the Volcker Rule will not restrict a bank holding company from holding collateralized debt obligations backed by trust-preferred securities (“TruPS CDOs”). If passed, H.R. 3819 would serve as a conduit for the systemic proliferation of toxic credit risks throughout the economy.

TruPS CDOs are securitized debts that use trust preferred securities as collateral. Trust preferred securities are hybrid instruments that have been issued primarily by small, unrated banks that themselves have vast exposures to localized commercial real estate loans. Thus, purchasers of TruPS CDOs in effect take on risk associated with real estate loans having uncertain creditworthiness and hailing from all parts of the country. Purchasers of TruPS CDOs typically have very little transparency into the actual risk profile of these instruments (which relate to local real estate loans).

Most TruPS were issued by community banks between 2003 to 2007, which was the peak period for the origination of risky real estate loans offered under poor underwriting standards. Thus, the creditworthiness of TruPS (and consequently TruPS CDOs) is inextricably tied to the performance of these banks’ pre-crisis commercial loan books. Many of the dangers associated

¹ Occupy the SEC (<http://occupythesec.org>) is a group within the New York-based Occupy Wall Street (“OWS”) protest movement. We are a group of concerned citizens, activists, and financial professionals with decades of collective experience working at many of the largest financial firms in the industry. Together, we make up a vast array of specialists, including traders, quantitative analysts, compliance officers, technology and risk analysts. We hope that our technical expertise provides a clear voice advocating for the American public amidst the cacophony of spin emanating from the powerful financial services lobby.

with these pre-crisis loans have yet to reveal themselves, and so TruPS present a veritable ticking timebomb of risk.

Whereas a single TruP security implicates the credit risk associated with one issuing bank, TruPS CDOs pool and concentrate the risk associated with many issuing banks. To make matters worse, community banks have also been the primary purchasers of TruPS CDOs (in addition to being TruPS issuers). The high level of interconnectedness between TruPS CDO issuers and purchases exacerbates the already-troubling risk of contagion that these products present. As a result, a single default by a TruPS-issuing community bank has the potential to enmesh a wide swathe of firms in the banking industry.

It comes as no surprise, then, that researchers at the Federal Reserve Bank of Philadelphia have singled out TruPS CDOs as particularly risky products that, across the board, “are likely to perform poorly.”² These experts “estimate that large numbers of the subordinated bonds and some senior bonds will be either fully or partially written down, **even if no further defaults occur going forward.**”³

By inscribing an exemption for TruPS CDOs into the Volcker Rule, H.R. 3819 would undermine the central purpose of the Rule by permitting risk associated with subordinated real estate loans to spread like contagion through the banking sector. Under this amendment, *all* bank holding companies, and not just community banks, would be permitted to speculate in the commercial real estate market using money loaned to them by depositors and the Federal Reserve. This outcome flies in the face of the basic premise of the Volcker Rule.

Further, H.R. 3819, as drafted, would facilitate broader evasion of the Volcker Rule’s restriction on proprietary trading by bank holding companies. The amendment permits the purchase of a CDO interest provided that the CDO is “predominantly backed by trust-preferred securities.” Thus, a banking entity could speculate on *virtually any asset type, no matter how risky*, so long as that asset is placed in a CDO vehicle comprised at least 50.1% of TruPS. The dangers attendant to this outcome should be clear to members of the Committee.

TruPS are but one of hundreds of asset classes that could fall under the purview of the Volcker Rule. The Committee should be aware that granting a specific exemption here will only lead to increased clamor for exemptions for other assets classes. We are already witnessing such a clamor arising in the wake of the recent concessions regarding TruPS CDOs granted by the country's financial regulators.⁴ For instance, the financial lobbying organization SIFMA has been recently exhorting regulators to broaden the exemptions in the Volcker regulations to include assets like senior debt issued by CLOs.⁵ Each such additional exemption that the

² Larry Cordell, Michael Hopkins & Yilin Huang, *The Trust Preferred CDO Market: From Start to (Expected) Finish*, Working Paper No. 11-22 (Federal Reserve Bank of Philadelphia), June 2011.

³ *Id.* (emphasis added).

⁴ Interim Final Rule, Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard To Prohibitions and Restrictions on Certain Interests in, And Relationships with, Hedge Funds and Private Equity Funds (Jan. 17, 2014), available at <http://www.sec.gov/rules/interim/2014/bhca-2.pdf>.

⁵ See, e.g., Cheyenne Hopkins & Jesse Hamilton, *Banks Push for More Changes to Volcker Rule Following CDO Fix*, BUSINESSWEEK, Jan. 16, 2014, at <http://www.businessweek.com/news/2014-01-15/banks-push-for-further-changes-to-volcker-rule-following-cdo-fix>.

industry can gain would further erode the basic protections of the Volcker Rule, which are absolutely essential to re-orient banks back towards conservative, customer-focused transactions. Even if major banks undergo significant costs in changing their business models to offload certain prohibited asset classes, those costs are required by Section 619 and are justified by the benefits to be had on a larger scale. Those benefits include, for instance, more prudent risk management that will make the job-creating functions of banks more viable.

Section 619 of the Dodd-Frank Act has already been passed, and Congress is wasting valuable time and resources in considering amendments that would dilute its effect. We urge the Committee to move on to other pressing matters relating to much-needed financial reform, and allow the SEC, the CFTC and the banking agencies to vigorously implement the Volcker Rule, as originally intended by Congress, so that the economy might actually realize the intended long-term benefits of the rule.

Thank you.

Sincerely,

/s/

Occupy the SEC

Akshat Tewary

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et al