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November 29, 2023

The Honorable Michael Barr
Vice Chair for Supervision, Board of Governors of the Federal Reserve System
Constitution Avenue & 20th Street NW
Washington, DC 20551

The Honorable Martin Gruenberg
Chairman, Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Mr. Michael J. Hsu
Acting Comptroller, Office of the Comptroller of the Currency
400 7th Street SW
Washington, DC 20219

Dear Vice Chair Barr, Chair Gruenberg, and Acting Comptroller Hsu:

I write to urge the banking agencies to evaluate the risks associated with "synthetic risk transfer" transactions, which allow banks to reduce their capital requirements by offloading risk to private market investors. I am concerned that synthetic risk transfers may not be conducted in a safe and sound manner by the banks under your supervision and that they may increase risk across the financial system.

According to industry reports and recent Federal Reserve legal interpretations, banks' interest in synthetic risk transfers have picked up in recent months and years. These complex arrangements are a potentially lucrative way for banks to arbitrage the capital rules by selling debt instruments or derivatives to unregulated nonbanks who assume the risk that a consumer or corporate borrower will default on a loan. While synthetic risk transfers are generally permitted, they have been strongly disfavored since the 2008 financial crisis when abuse of similar transactions magnified and obscured risks leading to devastating economic consequences.

Without a full assessment of the risks associated with synthetic risk transfers, I am concerned that widespread efforts to avoid stronger capital requirements put in place as a response to the 2008 crisis could expose the financial system to new risks. These risks seem to fall into two categories.

First, synthetic risk transfers move risk outside the banking system into opaque private markets where it may not be adequately managed and cannot be properly measured. Private market investors who assume credit risk from banks include private equity funds, hedge funds, private credit funds, and other big nonbank financial institutions. They are not subject to consolidated regulation and supervision, do not need to meet risk management requirements, and do not need to make public disclosures. While synthetic risk transfers are purportedly designed to diversify and disperse credit risk among many players in the financial markets, these transactions may in fact have the opposite effect by concentrating risk among a small number of very large shadow banks.

Second, synthetic risk transfers can encourage more risk-taking by banks. These transactions may free up additional capacity for banks to make more loans. But when risks of defaults and losses are shifted onto others, banks have fewer incentives to make prudent loans and to monitor how those loans perform. Instead of making additional loans, banks could take advantage of lower capital requirements through buying back shares or paying dividends to shareholders. But that may leave banks less able to absorb losses in a crisis.

Given these potential risks, I believe the banking agencies should take a very careful and judicious approach to synthetic risk transfers. In particular, I request the following information:

1. Volume of synthetic risk transfers conducted by the institutions under your supervision for each of the past ten years.
2. The amount by which institutions have been permitted to reduce their capital over the same time period.
3. The degree to which the identity and regulated status of a bank's counterparties affects the availability of synthetic risk transfers.
4. Whether there should be limits on how much capital can be reduced for different classes of assets, especially consumer loans.
5. Assessment of the risks to individual banks and of systemic risks based on experience to date.

Finally, if the banking agencies notice a significant increase in the use of synthetic risk transfers, I urge you to initiate a notice-and-comment process that would provide both for public input and for a public explanation by the agencies of their positions.

Thank you for your attention to this matter, and I look forward to your prompt reply.

Sincerely,

Jack Reed
United States Senator

cc: Hon. Janet L. Yellen, Secretary of the Treasury and Chairperson of the Financial Stability Oversight Council
Hon. Gary Gensler, Chair, Securities and Exchange Commission
Hon. Rostin Behnam, Chairman, Commodity Futures Trading Commission