August 1, 2013

Mr. Robert deV. Frierson
Secretary, Board of Governors of the Federal Reserve
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Prohibition Against Federal Assistance to Swaps Entities (Regulation KK), (RIN 7100-AD96)

Dear Mr. deV. Frierson:

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System ("Board") in response to the request for public comment in connection with Notice of Proposed Rulemaking ("Proposed Rule") published on June 10, 2013, in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

Branches and agencies of foreign banks ("FBAs") play a significant role in the U.S. financial system. In 2011, their total assets were over $2.2 trillion and accounted for 12.8 percent of total assets in the U.S. banking market.[2] Most FBA assets – more than $2.17 trillion in 2011 – are held by entities that not do not have deposits insured by the Federal Deposit Insurance Corporation ("FDIC").[3] FBAs accounted for approximately two thirds of all the assets held by foreign banking organizations ("FBOs") in the U.S. in 2011.[4]

Under section 716 of the Dodd Frank Act ("Act"), the so-called "swaps push-out rule," no swaps entity may receive federal assistance in the form of a Federal Reserve discount window or emergency loans. Since FBAs are eligible for federal assistance, it would appear that they are prohibited by the statute from acting as a swaps entity.

---

1 Better Markets is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular in the rulemaking process associated with the implementation of the Dodd-Frank Act.

2 W. Goulding and D. Nolle (2012). Foreign Banks in the U.S.: A primer, Board of Governors of the Federal Reserve International Finance Discussion Paper No. 1064, Tables 1 and A.5, *available at* http://www.federalreserve.gov/pubs/ifdp/2012/1064/ifdp1064.pdf. The U.S. banking market is defined as U.S. Domestic Banks + U.S. branches and agencies of foreign banks + U.S.-chartered foreign-owned subsidiary banks.

3 *Ibid*, Table A.1.

4 *Ibid*.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

However, the Proposed Rule would nonetheless allow FBAs to act as swaps entities in certain circumstances.[5] Section 716 has a limited exception for "insured depositories," which are allowed to engage in *bona fide* hedging and to act as swaps entities for specific categories of swaps, even though they are eligible for federal assistance. The Proposed Rule offers two lines of argument for extending the insured depository exception to non-insured FBAs.

First, the Proposed Rule makes a legal argument that in the "context" of Section 716, the exemption should be extended because FBAs are treated **similarly** to actual insured depositories with respect to federal assistance and enforcement rules. However, this argument ignores important differences in the regulatory treatment of FBAs and depositories. As we show below, U.S. law applies a more rigorous safety and soundness regime to insured depositories. So if we want regulation of FBAs and insured depositories to be similar – i.e. to have similar effects on safety and soundness and systemic risk – there is no *a priori* reason to believe that the Proposed Rule makes sense.

Second, the Proposed Rule merely assumes that since Section 716 is intended to reduce systemic risk, extending the exception to FBAs is consistent with that goal. However, as we show below, FBAs have highly volatile liability structures as well as relatively weak capital requirements. Therefore the exemption would locate swaps entities – which can themselves be the source of run risk and loss in stressed financial conditions – in firms that are less well prepared to deal with financial stress than insured depositories. This would appear to increase, not reduce, systemic risk.

Therefore, given that both the offered arguments supporting the Proposed Rule fail, there is no basis to extend the insured depository exception to non-insured FBAs. However, if FBAs are nonetheless allowed to operate swaps entities in the same manner as insured depositories, then at a minimum they must also be required to comply with the same safety and soundness regulations that apply to insured depositories, which is the basis for the exception for them.

The legal argument for the FBA exception

The Proposed Rule makes the legal argument that, even though the exemption in Section 716 applies to "insured depositories," the term is not defined in the section. The Proposed Rule, therefore, refers to language in Section 2 of the Act, which says that "except as the context otherwise requires..." the meaning of "insured depository" is in fact a depository with deposits insured by the FDIC. The Proposed Rule therefore focuses on the "context" of Section 716.

[5] Federal Register, Volume 78, No. 11, 34545-34550.

The Proposed Rule points out that FBAs are eligible for federal assistance, just like insured depositories. It also points out that FBAs are treated as if they were "insured depositories" for purposes of 12 U.S.C. §1818, which grants certain kinds of enforcement authority over insured depositories to federal banking agencies. The Proposed Rule does recognize that commercial lending companies owned or controlled by foreign banks are also treated as "insured depositories" for the purposes of §1818. But it nonetheless argues that since FBAs are treated similarly with respect to federal assistance and enforcement, the push-out exemption that applies to actual depositories should also apply to FBAs.

Unfortunately, this hyper-technical legal discussion of "context" in the Proposed Rule neglects to mention the material fact that FBAs are distinguished from actual insured depositories by the relative weakness of the safety and soundness rules that apply to them:

1. Unlike domestic banks, FBAs are not directly subject to:

- the U.S. implementation of the Basel III leverage and risk-based capital regulations;
- the proposed supplemental leverage ratios for very large bank holding companies and their commercial bank subsidiaries; or
- any supplementary risk-based capital requirements that the U.S. may impose on so-called very large bank holding companies.[6]

Instead the FBO which owns the FBA merely self-certifies that, at a consolidated level, the parent company meets home country capital standards broadly consistent with Basel III, and that home country stress tests are broadly consistent with those in the U.S.[7]

It is doubtful that such a certification can be monitored effectively. As the Federal Reserve has acknowledged, "...U.S. supervisors, as host authorities, have limited access to timely information on the global operations of foreign banking operations. As a result, monitoring compliance with any enhanced prudential standards at the consolidated foreign banking organization would be difficult..."[8]

---

6 Office of the Comptroller of the Currency, Federal Reserve System, and Federal Deposit Insurance Corporation, Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions, Joint Notice of Proposed Rulemaking, July 9, 2013, *available at* http://www.fdic.gov/news/news/financial/2013/fil13033.html.

7 Federal Register, Volume 77, No. 249, 76633. FBAs are required to maintain 30-day liquidity buffers, and to meet counterparty concentration limits.

8 *Ibid*, 76637.

In fact, the inability to monitor FBOs is one of the reasons that the Federal Reserve has appropriately proposed placing all U.S.-chartered FBO subsidiaries in intermediate holding companies ("IHCs"), where U.S. capital, leverage, and stress test requirements can be required. [9]

2. While FBAs may be subject to "early remediation" requirements if the FBO or its U.S. IHC hit certain triggers, remediation is not triggered by conditions in the FBA alone. Therefore, the FBA can be substantially out of compliance with the remediation triggers – which include leverage, risk-based capital, and stress-testing – and face **no** remedial action.

   In fact, there is historical precedent for this kind of divergence. In 2011 Taunus, Deutsche Bank's U.S. bank holding company, had negative regulatory Tier 1 leverage and Tier 1 risk-based capital ratios, although the parent FBO was within home country capital requirements at a consolidated level.[10]

3. Because FBAs are limited to accepting uninsured wholesale deposits, they do not contribute to the Deposit Insurance Fund ("DIF"), although they benefit from the stability effects of deposit insurance in domestic banks. Moreover, while chartered banks are jointly liable for losses to the DIF that are incurred when the FDIC resolves a failed bank, FBAs have no such liability. Therefore, unlike actual depositories, FBAs enjoy some of the benefits conferred by deposit insurance without any of the burdens.

It is therefore clear that, while U.S. law gives U.S. insured depositories federal assistance and subjects them to §1818 enforcement actions, it also applies a much more rigorous safety and soundness regime than is required of FBAs. If the goal is to increase, or at least not degrade, the similarity in outcomes produced by FBA regulation, then the exemption should not reduce the safety and soundness of individual FBAs, or reduce financial stability generally. The following section shows that this is not likely to be the outcome.

---

[9] For a discussion of the IHC requirements for FBOs *see* http://www.bettermarkets.com/sites/default/files/125-%20FRS-%20CL-%20Enhanced%20Prudential%20Standards-%204-15-13.pdf.

[10] Taunus Corporation, FR Y-9C, December 31, 2008. In 2008 Taunus was one of the 10 largest bank holding companies in the U.S by assets. During the financial crisis Deutsche Bank, the parent of Taunus, ranked 9th with respect to the peak amount borrowed from the Federal Reserve discount window and emergency lending facilities, *see* the data at http://www.bloomberg.com/data-visualization/federal-reserve-emergency-lending/#/overview/?sort=displayName&group=none&view=peak&position=0&comparelist=&search=.

The financial stability argument for the FBA exception

The Propose Rule also justifies the FBA exemption on the grounds that it will help to "...reduce systemic risks from derivative activities" by permitting FBAs to "continue the same risk-mitigating hedging and other activities permitted for insured depository institutions." [11] This argument is utterly puzzling. FBOs can always hedge the risk in their FBAs without operating a derivatives desk inside the FBA itself. So permitting a swaps entity in an FBA is irrelevant to hedging or the incentive to engage in it.

Moreover, because swaps dealers are subject to destabilizing runs during times of financial stress, they should be located in entities with strong equity buffers and with stable liability structures that can mitigate run risk.[12] However, as has already been pointed out above, leverage and equity requirements for FBAs are **weaker** than those required for insured depositories. In addition, FBAs have very volatile liability structures. Federal Reserve Governor Jerome Stein has emphasized this, noting that:

> "...the dollar liabilities of foreign banks have grown rapidly in the past two decades and now stand at about $8 trillion, roughly on par with those of U.S. banks. A significant proportion of foreign banks' dollar liabilities are raised via U.S. branches, most of which are legally precluded from raising deposits insured by the Federal Deposit Insurance Corporation. The main source of funding for these branches, therefore, comes from uninsured wholesale claims such as large time deposits, making the cost and availability of such dollar funding highly sensitive to changing perceptions of these banks' creditworthiness." [13]

The dollars raised by foreign banks are used to finance the purchase of U.S. assets and to finance dollar lending inside the U.S. and around the world. [14] These loans and assets often have longer maturities than the dollar liabilities supporting them.

During the financial crisis the exposure of FBOs and their parent banks to short-term dollar funding became a serious problem. As questions about their solvency (and that of other banks) increased, interbank lending markets froze, money market funds withdrew from lending to foreign banks (including withdrawing time deposits from their U.S.

---

[11] Federal Register, Volume 78, No. 111, 34546.

[12] For a description of the run risks posed by swaps entities see Financial Crisis Inquiry Commission (2011). The Financial Crisis Inquiry Report, Washington, D.C.: U.S. Government Printing Office, 287-88, 291, 343.

[13] J. Stein (2012). Dollar Funding and Global Banks, December 17, *available at* http://www.federalreserve.gov/newsevents/speech/stein20121217a.htm.

[14] B. Bernanke et al. (2011). International Capital Flows and the Returns to Safe Assets in the United States 2003-2007, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, Number 1014.

branches), the FX swap markets were disrupted,[15] and there were runs on ABCP issued by bank subsidiaries and off-balance-sheet special purpose vehicles. [16]

The run on short-term dollar funding caused foreign banks to increase lending rates and reduce lending in the U.S. and elsewhere. The banks were also faced with the prospect of selling large quantities of longer-maturity assets, funded with short-term dollar liabilities, at fire sale prices. [17]

The vulnerabilities of foreign banks that depend on short-term dollar funding resurfaced during the European sovereign debt crisis, which caused U.S. money market funds to reduce their exposure to euro-area banks significantly.[18] FBOs in the U.S. experienced a run on their deposits, mainly from U.S. money market funds, and as a consequence cut their commercial and industrial lending in the U.S.[19] The Federal Reserve reauthorized dollar swap lines to several foreign central banks in November 2011, although they have not been used.

Therefore, if we are concerned with enhancing U.S. financial stability, as the Proposed Rule states, it is highly undesirable to allow weakly capitalized FBAs with volatile liabilities to operate swaps entities in the U.S.

CONCLUSION

There is clearly no legal basis for extending the swaps push out exception to FBAs. Moreover, there is good reason to believe that extending it, while allowing FBAs to operate under relatively weak safety and soundness requirements, could easily increase systemic risk in the U.S. financial system.

---

15 *See* the Better Markets comment letters "New Information on the Proposed Exemption of Foreign Exchange Swaps and Futures: Fed Data Show Collapse of Foreign Exchange Markets During Financial Crisis" (Feb. 25, 2011), *available at* http://www.bettermarkets.com/sites/default/files/Treas-%20Comment%20Letter%20%28followup%29-%20Forex%20Swaps%202-25-11.pdf; and "Notice of Proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act" (June 6, 2011), *available at* http://www.bettermarkets.com/sites/default/files/Treas-%20Comment%20Letter-%20ForEx%20Swaps%20and%20Forwards%20Under%20CEA%206-6-2011.pdf (showing that $1.7 trillion injected into swap lines in 30 days after collapse of Lehman Brothers and $5.4 trillion injected in the 90 days).

16 P. McGuire and G. von Peter (2009). The US dollar shortage in global banking, BIS Quarterly Review, March, 58.

17 *Ibid*, 54, estimates that in mid-2007 short-term dollar funding of longer maturity assets by European banks was at least $1.1 - $1.3 trillion, and probably much larger.

18 V. Ivashina, D. Scharfstein, and J. Stein (2012). Dollar Funding and the Lending Behavior of Global Banks, Board of Governors of the Federal Reserve, International Finance Discussion Paper Number 2012-74.

19 R. Correa et al. (2012). Liquidity Shocks, Dollar Funding Costs, and the Bank Lending Channel During the European Sovereign Debt Crisis, Board of Governors of the Federal Reserve, International Finance Discussion Paper Number 2012-1059.

Therefore, FBAs should not be allowed to operate swaps entities in the same manner as insured depositories. However, if, after further consideration, input, analysis and a re-proposed rule, it was somehow determined that permitting such activities might be acceptable or desirable, then FBAs must be required to also comply with the same safety and soundness regulations that apply to those depositories.

We hope these comments are helpful in your consideration of the Proposed Rule.

Sincerely,

Dennis M. Kelleher
President & CEO

Marc Jarsulic
Chief Economist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
mjarsulic@bettermarkets.com

www.bettermarkets.com