Testimony of

Keith Bailey

On Behalf Of The

Institute of International Bankers

Before the

U.S. House of Representatives

House Committee on Agriculture

Subcommittee on General Farm Commodities and Risk Management

"To review H.R. 3283, the "Swap Jurisdiction Certainty Act", H.R. 1838 to repeal Section 716 of Dodd-Frank, and H.R. ___, the "Swap Data Repository & Clearinghouse Indemnification Correction Act of 2012""

March 28, 2012

Chairman Conaway, Ranking Member Boswell and members of the Subcommittee.

My name is Keith Bailey. I am a Managing Director in the Fixed Income, Currencies and Commodities Division of Barclays where I have responsibilities for evaluating and implementing the changes to our derivative businesses globally resulting from enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). I have over twenty five years of experience in the derivatives market both here in the U.S. and abroad. I am very pleased to be here today to testify on behalf of the Institute of International Bankers (IIB) in support of H.R.

3283, H.R. 1838, and “the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2012."   H.R. 1838 addresses a technical correction of critical importance to IIB’s membership. The other two pieces of legislation will provide greater certainty with respect to the cross-border regulation of swaps, while preserving the protections put in place by Dodd-Frank and helping to insure that the global swaps market operates optimally for the benefit of both investors and end users.

The IIB represents internationally headquartered financial institutions from over 35 countries around the world; its members include international banks that operate branches and agencies, as well as bank, securities broker-dealer and futures commission merchant subsidiaries, in the United States. In the aggregate, our members’ U.S. operations have approximately $5 trillion in assets and provide 25% of all commercial and industrial bank loans made in this country, which includes agriculture lending, and contribute to the depth and liquidity of U.S. financial markets. Our members also contribute more than $50 billion each year to the economies of major cities across the country in the form of employee compensation, tax payments to local, state and federal authorities, as well as other operating and capital expenditures.

At the outset, let me say that the IIB and its members support Dodd-Frank’s objectives of reducing systemic risk and increasing transparency in the financial markets. Many IIB members’ home country jurisdictions are also working to supplement their existing regimes to incorporate derivatives clearing and market transparency reforms to achieve regulatory objectives similar to those in Dodd-Frank and to support the commitments of the G-20 leaders to setting high, internationally consistent requirements for OTC derivatives (see below).

The swap markets are liquid, global markets that permit investors access to a range of risk management products and investment opportunities across a wide range of international financial markets. Unlike the futures and securities markets, swap markets are not dominated by regional exchanges. The global nature of the swap markets brings important benefits to U.S. end users and other market participants by increasing competition and liquidity.

H.R. 3283

H.R. 3283, *the Swaps Jurisdiction Certainty Act*, introduced by Representative Himes and Garrett provides certainty with respect to the extraterritorial application of Title VII and will ensure there is a level playing field between U.S. and foreign banks with respect to their cross-border swap activities.

While Title VII of Dodd-Frank lays the framework for the U.S. regulation of swaps, it also recognizes the need for international coordination of swaps regulations and, in Sections 722(d) and 772(c), the need to limit the extraterritorial application of Title VII.

Many other countries have regulated swap dealers, including branches and affiliates of U.S. firms, for years under their existing regimes for regulation of market professionals. G-20 leaders agreed to OTC derivatives regulatory objectives in September 2009, which called for: the trading of all standardized OTC derivative contracts on exchanges and their clearance through central counterparties; reporting of OTC derivatives contracts to trade repositories; and the imposition of higher capital requirements on OTC derivatives contracts that are not centrally cleared.

Consistent with that agreement, the European Union ("EU"), for example, is undertaking regulatory reforms with respect to enhanced pre- and post-trade transparency requirements, clearing of OTC swaps, segregation of client collateral, and the use of organized trading venues.

Existing and proposed EU legislation also broadly address business conduct by market professionals. Similar measures are being contemplated by the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC).

However, when these regulatory efforts are neither coordinated nor take into account their extraterritorial impact they can lead to conflicting requirements. For example, firms may be subject to an obligation to clear the same OTC swap as a matter of both U.S. and European regulation. We are hopeful that there will be an agreement between the CFTC and the SEC and regulators from other regions and countries, including the EU, Asia and Canada, to address this issue, as it is impossible to clear the same contract through two clearinghouses. Even with such agreement, issues of likely greater divergence may exist, such as when differing regions implement differing approaches to which products need to be cleared; what exemptions, if any, there will be for any sectors of the markets; and, how collateral is to be protected by clearinghouses and clearing members. Finally, there is no guarantee that the rules being drafted in the U.S. and the EU relating to the permitted execution venue for swaps will be sufficiently similar to allow mutual recognition.

These conflicts, which can occur as a result of the extraterritorial application of swaps regulations, can result in a number of other harmful results. It is not disputed that internationally headquartered banks' transactions with U.S. persons from outside the United States may trigger the registration and regulatory requirements prescribed under Title VII. However, if internationally headquartered firms with U.S. operations are subject to U.S. regulation of business conducted with non-U.S. persons, they face the risk of operating at a competitive disadvantage relative to an international firm that lacks a sufficient U.S. nexus to be subject to such rules. As a result, international firms with operations in the U.S., many of which use a single internationally located "central booking location" to book swaps, may choose to establish separate subsidiaries in the U.S. to try to limit these conflicts. However, this would be capital inefficient, introduces risk management concerns, is disadvantageous to large clients (who themselves prefer to transact globally), and potentially leads to inconsistent prudential regulation. This "silo" or "fragmented" approach may also result in U.S. end users having difficulty accessing overseas markets directly.

The extraterritorial application of Title VII is a very real concern. The industry has been engaged in ongoing dialogue with the CFTC, SEC and other regulators, and has sought guidance on the territorial scope of Dodd-Frank from the inception of the rulemaking process. Nevertheless, nearly every question on this topic and related issues, such as the treatment of inter-affiliate transactions, guarantees and branches, remains open.

Against this backdrop, it is challenging that the CFTC finalized rules on January 11, 2012 requiring companies to register provisionally as swap dealers or major swap participants as soon as the definitional rules under Dodd-Frank go into effect. All indications are, however, that the CFTC will not have finalized its extraterritorial guidance by that time, and possibly without a sufficient transition period for companies to come into compliance. Other significant CFTC rules have yet to be finalized as well, making the business decision on how best to comply with the CFTC's provisional registration rules difficult.

H.R 3283 brings much-needed certainty to the question of the extraterritorial reach of Title VII. The bill makes certain that internationally headquartered banks' non-U.S. swap and security-based swap transactions will not be subject to U.S. regulatory requirements. The bill also provides certainty for both U.S. banks and the U.S. operations of internationally headquartered banks with respect to their swap and security-based swap transactions with non-U.S. persons.

With respect to internationally headquartered banks that register as swap entities under Title VII based on their transactions with U.S. persons, the bill makes certain that such banks may satisfy the capital requirements of Title VII by relying on their home country capital requirements, provided that such home country requirements are comparable to the requirements under Title VII and the bank's home country is a signatory to the Basel Capital Accords. This approach conforms to the approach that has been taken for many years by the banking regulators in assessing the capital of foreign banks for U.S. regulatory purposes. It also ensures that appropriate protections are in place with respect to transactions that involve U.S. persons.

H.R. 1838

This bill, as introduced and referred to the Committee, would repeal Section 716 of Dodd-Frank, also known as the swaps "push-out" provision. Our principal concern with Section 716 is the unintended and acknowledged oversight in according significantly different and negative treatment for uninsured U.S. branches and agencies of foreign banks compared to that provided to insured depository institutions. Many foreign banks operate uninsured branches and agencies in the U.S. In the aggregate, these branches and agencies have more than $2 trillion in assets. In addition to lending and engaging in certain securities, asset management and other similar activities, many such branches and agencies also engage in swap dealing. Dodd-Frank provides that branches and agencies engaged in swap dealing activity be required to register with the CFTC and/or the SEC with respect to their swap dealing activity. Accordingly, they will be "swap entities" under Section 716.

Section 716 generally provides that no "Federal assistance" may be provided to any swaps entity with respect to any swap, security-based swap or other activity of the swap entity. "Federal assistance" is defined to include advances from the discount window and FDIC insurance. Uninsured U.S. branches and agencies of foreign banks are licensed by a federal or state banking authority; they are subject to the same type of safety and soundness examination and oversight as U.S. banks, and, like U.S. banks, they are eligible to borrow from the Federal Reserve discount window so long as the advance is secured by high quality collateral and subject to discount.[1] From the Federal Reserve's perspective, maintaining U.S. branches' and agencies' access to the discount window is an important tool for maintaining a sound and orderly financial system.

The general prohibition under Section 716 relating to Federal assistance applies to both U.S. FDIC-insured banks and uninsured U.S. branches and agencies of foreign banks that are swap entities. The general prohibition is, however, subject to several important exclusions, grandfathering provisions and transition periods, but these provisions apply only to "insured depository institutions" (IDIs). As a result, uninsured U.S. branches and agencies would appear not to be eligible for the exclusions, grandfathering and transition provisions applicable to IDIs.

When Section 716 was enacted, members of Congress acknowledged that this differential treatment of uninsured U.S. branches and agencies of foreign banks was "clearly unintended" and recognized the need "to ensure that uninsured U.S. branches and agencies of foreign banks are treated the same as insured depository institutions," consistent with the U.S. policy of

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[1] See Federal Reserve Regulation A, 12 C.F.R. § 201.1 (extending rules relating to eligibility for Federal Reserve Bank lending to "United States branches and agencies of foreign banks").

national treatment.[2] However, as was explained at the time, in the rush to complete the conference and finalize Section 716 there was no opportunity to rectify this "significant oversight."[3]

As a result, the exclusion in Section 716(d) that permits IDIs to continue to engage in certain traditional swap dealing activities, including dealing in interest rate and foreign currency swaps, and to use swaps for hedging and other similar risk-mitigating activities, would appear not to be available to uninsured U.S. branches and agencies of foreign banks. If uninsured branches and agencies that are swap entities were ineligible for this exclusion, then their U.S. customers would lose the benefit of trading with them. These customers would have to establish new trading relationships away from the U.S. branch or agency in order to engage in traditional swap transactions, as well as those swap activities that are not covered by the Section 716's exceptions. This would significantly reduce competition and worsen pricing in the U.S. swaps market, especially given that 8 of the 14 largest global derivatives dealers are foreign banks.

In addition, the resulting differential treatment relative to U.S. FDIC-insured banks would overtly discriminate against and competitively disadvantage foreign banks. This represents a significant departure from the long-standing U.S. policy that U.S. branches and agencies of foreign banks are subject to the same rules, regulations and oversight, i.e., national treatment, as U.S. banks. Finally, it would provide precedent for foreign jurisdictions to provide advantages to

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[2] 156 Cong. Rec. S5903-S5904 (daily ed. July 15, 2010) (colloquy between Senator Dodd and Senator Lincoln).

[3] Id.

their local banks at the expense of the foreign operations of U.S. banks, if not in the context of swaps then potentially in other contexts.

Section 716(b)(2)(B) also excludes from the scope of Section 716 an IDI that is a major swap participant or major security-based swap participant. This exclusion is important to those IIB members that may be deemed to be major swap or security-based swap participants. The definition of major swap participant encompasses not only persons engaged in ongoing swap activities but also potentially persons with only legacy positions. Thus, if uninsured branches and agencies were not treated as IDIs for this purpose, then they could be subject to Section 716 as a result of legacy positions in a way that a U.S. FDIC-insured bank would not.

Finally, Section 716(e) provides that Section 716's prohibition on Federal assistance "shall only apply to swaps or security-based swaps entered into by an insured depository institution after the end of [Section 716's] transition period." Therefore, the existing swaps of IDIs are grandfathered from Section 716. Relatedly, Section 716(f) gives an IDI's appropriate Federal banking agency the authority to grant the institution a transition period of up to three additional years beyond Section 716's July 16, 2013 effective date before the institution must divest or cease its swap activities. The purpose of this transition period is to prevent the restructurings necessary to comply with Section 716 from adversely disrupting the institution's lending and other non-swaps activities. But this provision is available only to IDIs.

The implications of these issues are potentially serious. There are approximately 16 months before uninsured U.S. branches and agencies that are swap entities must "push out" all their existing swap positions and ongoing swaps activities, which is precious little time, particularly relative to the longer period—up to more than four years—before IDIs will have to make their transition. Moreover, the absence of any grandfathering of existing positions would mean that the transition for foreign banks and their counterparties would be much more disruptive, more similar to insolvency in many respects than to an orderly business restructuring. This is true because:

- Swap dealing is typically conducted as an integrated part of a bank's lending and other non-swap businesses. Swap positions often hedge loan and other non-swap positions, and risk management and other systems are often shared across many different types of trading activities, not just those involving swaps. Winding down or restructuring swap dealing activities will as a result tend to decrease lending and market-making activity, with material adverse effects on the U.S. economy.

- A significant number of customers have master agreements directly with the uninsured U.S. branches and agencies of foreign banks, or have multi-branch netting agreements to which one or more uninsured U.S. branches or agencies are parties. The assignment or novation of these agreements, even to an affiliate, almost always requires counterparty consent, forcing customers and foreign banks to negotiate the terms for assigning, novating or modifying agreements for swap portfolios held with uninsured U.S. branches and agencies. Major swap dealers have thousands of clients who would be affected.

- International banks and their customers may not always agree to the terms of an assignment or novation, thereby forcing the parties to litigate over whether Section 716 triggers "illegality" and similar provisions in those agreements.

- Renegotiation and litigation will lead to delays in trading; resulting in diminished liquidity and higher spreads for customers.

- Assignment or novation could also potentially trigger other requirements under Dodd-Frank, such as mandatory clearing and trading requirements inasmuch as any such novated or assigned swap potentially would constitute a new swap that would be subject to those requirements.

- There are significant capital and technology costs associated with using a new booking structure, and the modification of existing systems to track new booking structures will put a very heavy strain on information technology resources that are already overwhelmed with the other changes necessary because of Dodd-Frank.

While the underlying bill deals with this disparate treatment of uninsured branches and agencies of foreign banks by striking Section 716 in its entirety, the bill recently approved by the House Financial Services Committee modifies Section 716. The IIB supported this amendment, which was co-sponsored by Representatives Himes and Maloney and the bill's sponsor Representative Hayworth, as it provided U.S. branches and agencies parity with insured depository institutions.

<u>Swap Dealer Definition</u>

In this connection, we would like to thank Chairman Lucas for his attention to another instance in Dodd-Frank where uninsured U.S. branches and agencies of foreign banks are similarly harmed compared to insured depository institutions. Section 721 defines "Swap Dealer" (Section 1a(49) of the Commodity Exchange Act (CEA)) to exclude "insured depository institutions" which "enter into a swap with a customer in connection with originating a loan with that customer." Because the exclusion is limited to IDIs, **any** uninsured U.S. branch or agency of a foreign bank potentially will have to register with the CFTC if it enters into a swap in connection with its lending activities. Requiring these uninsured U.S. branches and agencies to register could have an impact on their willingness to lend in this country and strain the supervisory resources of the CFTC. We would urge members to support a fix to this definition that would provide uninsured U.S. branches and agencies of foreign banks the same treatment accorded IDIs under Section 1a(49) of the CEA .

<u>Swap Data Repository and Clearinghouse Indemnification Correction Act of 2012</u>

Under Dodd-Frank, OTC derivatives transactions are required to be reported to swap data repositories and securities-based swap data repositories. Dodd-Frank contemplates that information reported to the CFTC by derivatives clearinghouses and information reported to data repositories can be accessed by U.S. and foreign regulators. However, access to such information is conditioned on the recipient agreeing to keep such information confidential and to indemnify the CFTC or data repository, as the case may be, for "any expense arising from litigation relating to the information provided." This indemnification requirement is a significant barrier to foreign regulators and, in some instances, to U.S regulators to obtaining this data. The *Swap Data Repository and Clearinghouse Indemnification Correction Act of 2012* would eliminate this barrier. The IIB supports the bill and urges its approval by the Committee.

Conclusion

Thank you for the opportunity to testify today on behalf of the IIB. We urge the Committee to consider and approve these important bills.

KEITH A BAILEY

Keith Bailey is a Managing Director in the Fixed Income Currencies and Commodities division of Barclays, based in New York, with responsibility for Market Structure, including assessing the impact of the provisions of the Dodd Frank Act on its businesses.

He joined Barclays in 2008 in Asia, where he was COO for the Trading and Markets division for the region

From 1987 until 2007 he was at Merrill Lynch, principally based in New York, in a variety of trading and business COO roles, including head trader for the US Dollar interest rate swap book and more recently COO of its Rates and Commodities Business. He also has experience with commodity futures and fixed income prime brokerage. From 1997 to 1999 he ran Merrill Lynch's Debt Markets Business in Australia.

He qualified as an attorney in the UK after receiving a degree in law from Cambridge University

While at Merrill Lynch, he also served as Chairman of the Board of Directors of the International Swaps and Derivatives Association from 2000 – 2004.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2009.

Name: Keith Bailey

Organization you represent (if any): Institute of International Bankers

1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2009, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: ______________________ Amount: __________

Source: ______________________ Amount: __________

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2009, as well as the source and the amount of each grant or contract:**

Source: ______________________ Amount: __________

Source: ______________________ Amount: __________

Please check here if this form is NOT applicable to you: __________

Signature: Keith Bailey

* Rule XI, clause 2(g)(5) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

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