**By TNT**

**COMMENT**

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**Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping – Proposed Rule**

**File Number S7-16-11**

Dear Mr Stawick and Ms Murphy,

We refer to our letter of 18 March 2011 to Mr Ananda Radhakrishnan of the Commodity Futures Trading Commission (the "**CFTC**") and Mr James Brigagliano of the Securities and Exchange Commission (the "**SEC**", and together with the CFTC, the "**Commissions**"). As stated in that letter, the Bank for International Settlements (the "**BIS**") supports the introduction of mandatory central clearing requirements for OTC derivative transactions as a key element of reducing systemic risk in the global financial system. The recent financial crisis exposed weaknesses in the structure of OTC derivative markets that contributed to the build-up of systemic risk. In the US, these weaknesses are addressed in Title VII of the Dodd-Frank Act (the "**Act**"). The BIS commends the Commissions on the progress made in preparing rules for the implementation of the Act and wishes to express its appreciation for the significant role that the Commissions are playing in this regard. In the same vein it would like to support the work of the Commissions by responding to the invitation of Commissioner Sommers to comment on certain issues involving transactions with certain foreign or multinational entities published in the Federal Register.

On 23 May 2011 the Federal Register published the Commissions' joint proposed rule dealing, inter alia, with the further definition of the terms "swap" and "security-based swap". The proposed rule deals with the classification, for

the purposes of these terms, of certain categories of financial transactions, such as insurance contracts, forward contracts and certain types of credit derivatives. The Commissions state, at § II.A of the commentary to the proposed rule, that "*the statutory definitions of "swap" and "security-based swap" are detailed and comprehensive*" and that "*the Commissions believe that extensive "further definition" of the terms by rule is not necessary*". However, in our letter of 18 March 2011 we drew attention to the consequences for the BIS and other public authorities, central banks and international public organisations of applying the provisions of the Act to them without differentiation from commercial market participants having regard to their special roles and functions.

The Act specifically excludes from the scope of the definitions of "swap" and "security-based swap" any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States. The Act contains no specific reference to the special position and mission of central banks and international public organisations such as the BIS. However, given the overall objective of the Act to reduce systemic risk, it would be entirely consistent with Congressional intent for the special position and mission of certain international public organisations and central banks to be recognised by the Commissions in their rulemaking. The operations of the BIS pose no threat to systemic stability or market integrity and at times of market stress, may even be employed by the international central banking community to assist in maintaining systemic stability.

**The BIS plays a unique role in the international financial system.**

***Bank for Central Banks***. The BIS is an international organisation established under the Hague Agreements of 1930.[1] The mandate of the BIS is to foster international monetary and financial cooperation and to serve as a bank for central banks and international public institutions. The BIS currently has 57 member central banks located worldwide, including all G20 members. In its banking activities, the BIS establishes customer relationships only with central banks, monetary authorities and international public institutions and provides a range of banking services to these customers that is predicated on confidentiality, its superior credit quality and its substantial capital reserves. The BIS is at the disposition of the international central banking community to assist in the management of their foreign reserves or to conduct such market operations on their behalf as may be appropriate. The BIS does not seek in its banking activities to maximise profit, but to support the performance of central banks' public interest mandates while ensuring an appropriate rate of return for its shareholding central banks.

***No National Regulatory Supervision***. In the conduct of its banking activities, the BIS is not subject to any national regulatory supervision. Any such national regulatory supervision would be inconsistent with its special status as an international public organisation founded by treaty. Rather, under its founding documents,[2] the activities of the BIS are to be collectively overseen by its Board of Directors, currently composed of 19 governors and deputy governors of

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1 Hague Convention respecting the Bank for International Settlements (20 January 1930).

2 Constituent Charter of the Bank for International Settlements (20 January 1930); Statutes of the Bank for International Settlements (20 January 1930, as amended).

central banks, and the Board has in turn established a number of committees to assist it in this regard.[3]

**The BIS makes use of a limited range of OTC derivatives in connection with the banking services it provides.**

The BIS engages in limited types of OTC derivatives contracts with selected financial market counterparties in connection with the services it provides to its central banking customers. These OTC derivatives are principally used to hedge interest-rate and foreign exchange risk arising from deposits entrusted to the BIS and to manage liquidity. The BIS does not engage in more complex types of derivative contracts, such as credit default swaps or equity derivatives. Under normal circumstances, due in part to the composition of its derivative portfolio (comprising mainly short-term derivatives) and in part to the very high degree of collateralisation of this portfolio, the fair value of BIS derivative exposures is relatively modest.[4]

It should be noted that, in addition to its usual role as a depositary of central bank foreign reserves, the BIS could at times of financial market instability be called upon by its central bank customers to provide liquidity, particularly foreign exchange liquidity, to the central bank of the relevant country or countries. Such transactions could be large in volume and at short notice. The related hedging for those transactions could then require the BIS to engage in derivative transactions with commercial bank counterparties in the financial markets.

**With its unique role and strong risk controls and capital base, the BIS poses no risk to systemic stability.**

The BIS applies strong risk controls to its activities, including the derivatives activities described above.[5] BIS internal ratings and limit structures are determined at the highest executive levels of the organisation; only a narrow range of high quality government securities is admitted as collateral coverage. Derivative exposures are subject to stress tests that assume very adverse moves of relevant risk factors with a decline in value of related collateral over the holding period for stressed exposures.

At the same time, the BIS capital base is exceptionally strong.[6] When calculating economic capital requirements, the BIS uses a 99.995% confidence interval and a one-year time horizon. The extremely strong capital position of the BIS, its liquidity and its very low risk profile have been recognised by the assignment of a zero percent risk weighting to exposures against the BIS under the Basel II

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[3] Of particular relevance in this context are the Board's Banking and Risk Committee and its Audit Committee.

[4] The fair value of BIS collateralised derivative transactions at the end of March 2011 was SDR 1.64bn (USD 2.60bn). Collateral held in relation to these transactions was SDR 1.74bn (USD 2.76bn).

[5] Thus the BIS risk control unit is independent from risk taking units and employs independent credit assessments of counterparties, tight limit compliance controls through on-line limit checking and real time exposure measurement, strict documentation and collateralisation requirements, stress testing, as well as business concentration control.

[6] At the end of March 2011, BIS shareholders' equity was SDR 16.67bn (USD 26.40bn). The Bank's Tier 1 ratio, consistent with the Basel II framework, was 55.1%.

capital adequacy framework,[7] which is consistent with that assigned to the highest quality sovereign and supranational entities. The same risk weighting for the BIS has also been proposed by the relevant US authorities.[8]

BIS derivative activities thus pose no risk to systemic stability. At times of market stress, BIS banking operations may even be employed by the international central banking community to assist in maintaining systemic stability.

**The definitions of the terms, "swap" and "security-based swap", should be clarified to exclude transactions with international public organisations such as the BIS, and the Commissions have the authority do so.**

As stated above, the definitions in the Act of the terms, "swap" and "security-based swap", are broad enough to encompass many of the OTC derivatives in which the BIS engages with United States counterparties. This fact has multiple potential consequences for the BIS. Not alone does it mean that OTC derivatives entered into by the BIS must, where eligible, be submitted to mandatory central clearing, it also means that the BIS could conceivably fall within the scope of supervision by the CFTC as a "swap dealer" or "major swap participant". This result seems to us unlikely to be consistent with Congressional intent. As an organisation established under international treaty with the object of promoting international central bank co-operation, it would be of significant concern if the BIS were to become subject to the supervision of the prudential authorities of a single state. Prudential authorities could conceivably impose regulatory requirements on the BIS that would be inconsistent with its public mission, independence and status.

Concerns of a similar nature arising from the potential application of Title VII of the Act have, we understand, been expressed to the Commissions by other international organisations. We refer in this regard to the concerns expressed by The World Bank, on its own behalf and that of other multilateral development banks, in its letter of 5 April 2011 addressed to Commissioner Sommers of the CFTC, and to those expressed by the European Central Bank (the "**ECB**") in its letter of 6 May 2011 addressed to Mr Ananda Radhakrishnan of the CFTC and Mr James Brigagliano of the SEC. For the reasons of status and independence alone, we submit that the Commissions should avoid in their final rulemaking treating derivatives entered into by international public organisations and central banks in the same manner as those entered into by commercial bodies.

When implementing mandatory central clearing of OTC derivatives, the ability of international financial organisations to carry out their public interest functions should not be prejudiced. In particular, the necessary confidentiality inherent in the financial operations of such international public organisations and central banks or the liquidity available for the discharge of their functions at times of financial market stress should not be threatened. Concerns of this nature, which further militate in favour of differentiating the treatment of international public organisations and central banks from that of commercial bodies in the application of mandatory central clearing requirements, were also expressed in

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[7] See paragraph 56, http://www.bis.org/publ/bcbs128.htm.

[8] Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 *Fed. Reg.* 69288, 69409, 69426 (Dec. 7, 2007) (Section 31(d)(2) of the U.S. implementation of Basel II assigns the BIS an exemption to the normal 0.03 percent probability of default floor).

our letter of 18 March 2011. We understand that similar concerns have been communicated by other international organisations. We refer in this regard, for example, to the ECB's letter of 6 May 2011. The considerations involved in the management of foreign reserves are not amenable to control and supervision in the same way as private-sector profit-maximising transactions; while performance of the mandate of central banks (and in our submission, by extension, that of the BIS as bank to central banks) can require them to act confidentially in certain circumstances. The specificity of the role and functions of central banks therefore makes their use of clearing systems very sensitive, particularly in times of crisis. Undifferentiated application of Title VII of the Act to the OTC derivatives activities with United States counterparties of international public organisations, including the BIS, does not take these concerns into account. Indeed, central clearing of the BIS's OTC derivatives could absorb, through potential margin requirements, liquidity that might otherwise be needed by the BIS for its market activities in times of stress. Requiring the BIS or its financial counterparties to submit BIS trades to a clearing broker or a clearing house could threaten the confidentiality required by the BIS's central bank clients and impair the BIS's operational capability. Finally, the BIS represents counterparty risk of the highest calibre given its extraordinarily strong capital base and low risk profile. It is not apparent that directing transactions away from such an institution via mandatory clearing serves the objective of reducing systemic risk.

Anticipating that many situations would need to be addressed by regulators in the rulemaking process, Congress vested the Commissions, in our view, with the rulemaking authority to further define certain terms, including "swap" and "security-based swap." Section 721(b) of the Act provides that "...the [CFTC] may adopt a rule to define—(1) the term "commercial risk"; and (2) any other term included in an amendment to the Commodity Exchange Act [which includes the term "swap"]...", while Section 761(b) of the Act provides similar definitional authority to the SEC in relation to the Securities Exchange Act. These definitional authorities could be used to provide for differentiated treatment in relation to OTC derivatives entered into by particular categories of counterparties.

For the reasons set out above, we believe that the Commissions should exercise their rulemaking authority in this area to define the terms "swap" and "security-based swap" to exclude agreements, contracts or transactions a counterparty of which is the BIS, and we respectfully request the Commissions to do so.

The BIS once again wishes to express its appreciation for the work of the Commissions in this area. We would be pleased to provide any further information that you might require regarding the matters addressed in this letter.

Yours sincerely,

BANK FOR INTERNATIONAL SETTLEMENTS

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