

ISDA

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August 15, 2001

Via Federal Express

Ms. Jennifer J. Johnson,
Secretary,
Board of Governors of the Federal Reserve System,
20th Street & Constitution Avenue, N.W.,
Washington, D.C. 20551.

Attention: Docket Nos. R-1103; R-1104; R-1015 and R-1016
regs.comments@federalreserve.gov

Re: Proposed Regulation W and the Interim Final
Rules on Derivatives and Intraday Extensions of Credit

Ladies and Gentlemen:

The International Swaps and Derivatives Association, Inc. (“ISDA”) appreciates the opportunity to comment on the notice of proposed rulemaking, interim final rules and final rules (collectively, the “Proposal”)¹ issued by the Board of Governors of the Federal Reserve System (the “Board”) with regard to transactions between insured depository institutions (“Banks”) and their affiliates.

¹ The Proposal consists of:

- (i) a notice of proposed rulemaking (Regulation W) to implement comprehensively Sections 23A and 23B of the Federal Reserve Act;
- (ii) an interim final rule with request for public comment on the application of Sections 23A and 23B of the Federal Reserve Act to derivative transactions with affiliates;
- (iii) an interim final rule with request for public comment on the application of Sections 23A and 23B of the Federal Reserve Act to intraday extensions of credit to affiliates;
- (iv) a final rule on the applicability of Section 23A of the Federal Reserve Act to the purchase of securities from certain affiliates; and
- (v) a final rule on the applicability of Section 23A of the Federal Reserve Act to loans and extensions of credit made by a member Bank to a third party.

ISDA is a global financial trade association whose membership comprises more than 530 of the world's largest commercial, merchant and investment banks, corporations, governmental entities and other institutions. ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 530 member institutions from 41 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

The comments below address three specific aspects of the Proposal, namely derivative transactions between Banks and their affiliates, intraday extensions of credit by Banks to their affiliates and the "readily identifiable and publicly available market quotation" exemption from the quantitative restrictions of Section 23A.

I. Derivative Transactions Between Banks and Their Affiliates.

The Board has solicited public comment on the appropriate treatment under Section 23A of the credit exposure arising from derivative transactions between Banks and their affiliates. 66 Fed. Reg. 24231. ISDA agrees with the Board's view that derivative transactions between Banks and their affiliates should be treated as subject to Section 23B. 66 Fed. Reg. at 24231. As described below, ISDA strongly believes, however, that at most there is justification for subjecting only a narrow subset of such derivative transactions – those identified as abusive transactions through the examination process and further public comment – to Section 23A. In a complex and evolving market, relying on Section 23B and the fair market standards developed for dealing with third parties, which standards are subject to regulatory examination, is a superior approach to imposing a "one-size-fits-all" static regulatory regime.

1. A Regulatory Burden Should Only Be Imposed in Case of a Demonstrable Need for Government Regulation.

At the outset, as a broad policy matter, ISDA strongly believes that the Board should not impose the cost and burden of regulation under Section 23A on derivative transactions between Banks and their affiliates without clearly showing a need for such regulation or demonstrating that the goal of Bank safety and soundness cannot be accomplished through less obtrusive means. Moreover, ISDA believes that its approach is fully consistent with the Board's own articulated approach in this regard. It has long been the Board's position that the need for government regulation of financial markets is predicated on two principles. First, the regulator must clearly enunciate the public policy objectives that government regulation would be intended to promote. Second, the regulator should evaluate whether government regulation is necessary to achieve these objectives.² Therefore, the regulatory burden that would result from imposing the requirements of Section 23A on even a portion of the derivative

² See Remarks by Chairman Allan Greenspan, *Government Regulation and Derivative Contracts*, at the Financial Markets Conference of the Federal Reserve Bank of Atlanta, Coral Gables, Florida, February 21, 1997.

transactions between Banks and their affiliates must be justified by a clear showing of the risks posed to Banks in the absence of the requirements of Section 23A.

The derivatives market, especially the institutional derivatives market which is the relevant market for transactions between Banks and their affiliates, is well-developed and subject to robust market discipline. Derivative transactions are generally governed by well-established and standardized master documentation that is legally enforceable, enhances liquidity and facilitates risk management. Indeed, Chairman Greenspan has himself noted that “there appears to be no need for government regulation of . . . derivative transactions between institutional counterparties.”³ Given the well-developed risk management techniques in the institutional derivatives market and the absence of a demonstrated general problem with derivative transactions between Banks and their affiliates, the appropriate approach is to build on the robust and dynamic controls of the institutional derivatives market through application of Section 23B and not impose an entirely new “one-size-fits-all” regulatory regime through application of Section 23A. Simply put, ISDA believes that supervisory review of the standards of private market regulation of the institutional derivatives market, reinforced by the requirements of Section 23B, is preferable to regulation pursuant to Section 23A.

2. Derivative Transactions Should Be Treated as Subject to Section 23B.

Derivative transactions between Banks and their affiliates, with the possible exception of a narrow subset of abusive derivative transactions, would be effectively regulated pursuant to Section 23B. Efficient private regulation of derivative transactions between Banks and their affiliates can be achieved by holding these transactions to the robust standards of private market regulation supported by supervisory review, as described above, that have developed in the derivatives market between unaffiliated market participants.

Section 23B would require that each Bank have in place credit limits on its derivatives exposure to affiliates that are at least as strict as the credit limits the Bank imposes on unaffiliated companies that are engaged in similar businesses and are substantially equivalent in size and credit quality. Similarly, each Bank would monitor derivatives exposure to affiliates in a manner that is at least as rigorous as that utilized to monitor derivatives exposure to comparable unaffiliated companies. In addition, Section 23B would require each Bank to price, and require collateral in, derivative transactions with affiliates in a way that is at least as favorable to the Bank as the way the Bank would price, or require collateral in, a derivative transaction with comparable unaffiliated counterparties. Thus, as a policy matter, ISDA believes that application of the standards developed for derivative transactions with third parties to derivative transactions between Banks and their nonbank affiliates adequately protects Banks engaged in such transactions.

The unnecessary imposition of the quantitative and collateral requirements of Section 23A would serve as a significant impediment on Banks’ ability to facilitate efficient consolidated risk management. We submit that it is counterproductive from a risk management viewpoint to create regulatory barriers to transactions among affiliates that move risk from an

³ *Id.*

entity booking a transaction for business or regulatory reasons to an affiliate that is best suited to manage the related risk.

Furthermore, application of Section 23A is simply not the best way – or perhaps even an effective way – to protect a bank in the context of derivative products. For example, assume a deep in the money, covered equity call option was sold by a nonbank affiliate to a subsidiary of a member bank. Given that there will be a substantial premium paid for the option and there is a substantial likelihood of its exercise, the bank subsidiary would have credit exposure to its affiliate. The best way to mitigate that credit exposure from a risk management viewpoint would be to structure the transaction as a covered call (i.e., require the affiliate to deliver the security underlying the option to the bank subsidiary as collateral). If Section 23B were applied, this is likely to be how a collateral arrangement would be structured. Under Section 23A's requirements, however, the affiliate would either have to post more than 100 percent of the underlying security (i.e., more than it is likely to hold in connection with the transaction) or post other securities, possibly government securities, which in the context of this transaction would be an inferior risk mitigant.

Thus, in terms of both the overall risk management process at a banking organization and the risk management of specific transactions, we believe that Section 23A's quantitative and collateral requirements are inappropriate for derivatives transactions and inferior to reliance through Section 23B on the tailored risk management technologies developed by the industry for those transactions. Indeed, the very lack of clarity with respect to how to apply the quantitative limits of Section 23A to swaps and other derivative transactions is itself a further indicia of why Section 23A really does not fit well in the derivatives context.

In addition, as a legal matter, although over their lives derivative transactions may give rise to credit exposure, with the possible exception of a narrow class of credit derivative transactions, they do not fall within the definition of "covered transaction" in the statute. For example, in the case of interest rate swaps, the only categories of covered transactions into which they could potentially fall are a "loan or extension of credit" to an affiliate or a "purchase of assets" from an affiliate.⁴

If viewed as an extension of credit, a swap would not only be subject to the quantitative restrictions of Section 23A, but also to the collateral requirements. Loans involve the obligation to repay principal and interest. Swaps, however, typically do not result in the actual payment of notional principal amounts. In a swap transaction, generally, the only amount ever paid is the net amount owed by one party on a given payment date after subtraction of the lesser amount owed by the other party. Because the notional amount is not equivalent to the amount to be paid, the extension of credit for Section 23A purposes would presumably be based on some measure that reflects the current, and possibly future, risk of the swap. The lack of an obvious methodology for treating swaps as credit extensions under Section 23A is itself strong evidence that this is an inappropriate way in which to regulate swap transactions with affiliates. Moreover, it is likely that any methodology adopted for treating swaps as extensions of credit would result in amounts at risk which would vary over time, creating a moving and administratively burdensome target in terms of the amount of collateral restrictions of Section

⁴ See Ernest L. Patrikis, *Swaps and Other Derivatives in 1994: Bank Regulatory Issues*, 848 PLI/Corp 497 (1994).

23A. It would also create the anomalous result that a swap would be deemed a covered transaction only to the extent that the Bank is “in the money.”

If viewed as a purchase of assets, a swap would be subject only to the amount restrictions of Section 23A. The asset purchased would presumably be the right to receive payments in future and, as with a loan, would have positive value for the purposes of Section 23A only to the extent that the Bank is “in the money.” Typically, in a covered transaction pursuant to Section 23A, money leaves the Bank to fund or financially support an affiliate. A swap transaction, however, does not constitute a means of funding an affiliate – the concern addressed by Section 23A. Albeit in the context of intraday extensions of credit to affiliates, the Board itself acknowledges that full applicability of the requirements of Section 23A may not be warranted for certain transactions that are generally not used as a means of funding or otherwise providing financial support for an affiliate. Simply put, derivatives in general do not seem to fall within the statute’s coverage.

As a general matter, therefore, ISDA respectfully submits that there is neither a policy nor a legal basis for subjecting derivative transactions between Banks and their affiliates to Section 23A. Through supervisory review, the Board can effectively address potential abusive transactions should a Bank, for example, structure an extension of credit to an affiliate as a swap in an effort to circumvent the requirements of Section 23A.

ISDA also wishes to point out that the Board’s identification of three classes of derivative transactions in the Proposal as potentially subject to Section 23A⁵ does not adequately take into account the variances inherent in each of these derivative products. ISDA respectfully submits that these transactions identified by the Board are in fact broad generic classes of derivative transactions which, even if they possibly contain a limited number of abusive transactions, also include many transactions that do not raise a concern in terms of the policies underlying under Section 23A. In fact, in many cases they may enhance risk management. For example, the Proposal does not distinguish between an option that is deep-in-the-money at the time that it is entered into, and one that is at-the-money or near-the-money when entered into, but in time moves deep-in-the-money. Similarly, the Proposal does not recognize the difference between a credit swap that is hedged by a transaction with an investment grade counterparty, as opposed to one hedged by a transaction with a non-investment grade counterparty. ISDA believes that the particular facts and circumstances surrounding these derivative products are crucial in determining whether they should be subject to Section 23A.

In particular, ISDA believes that transactions that are entered into in the context of hedging customer transactions, irrespective of the specifics of the instruments involved in the transaction, do not pose a risk of the type Section 23A was designed to address. Section 23A was intended to protect a Bank by limiting its ability to fund, or provide credit support to, a

⁵ Specifically, the Board has indicated that (a) a deep-in-the-money option or swap is the functional equivalent of a loan, which is a covered transaction under Section 23A; (ii) a credit derivative between a bank and an affiliate in which the Bank provides credit protection to the affiliate with respect to the affiliate’s assets could be treated as a covered transaction; and (iii) a credit derivative transaction between a Bank and an unaffiliated company that references the obligations of an affiliate of the Bank could be treated as a guarantee by the Bank on behalf of an affiliate for purposes of Section 23A (66 Fed. Reg. at 24196).

nonbank affiliate. Hedges of customer transactions are simply not entered into for that purpose. They are instead a means of moving risk from one legal entity to another in order to promote risk management. Respectfully, the imposition of Section 23A's requirements to hedging transactions would make hedging more difficult and thus both impair the ability of banking organizations to provide derivative products to customers and impede risk management.

Thus, ISDA strongly believes that the wholesale treatment of broad classes of derivative products under Section 23A, without greater specificity as to their particular characteristics and context, is not appropriate. As set forth below, ISDA believes that the most prudent approach would be for the Board to set forth for public comment an additional proposal with regard to those specific derivative transactions that the Board has identified in the examination process as constituting an extension of credit by a Bank to, or guarantee by a Bank of, an affiliate that should be covered under Section 23A. These specific abusive transactions identified by the Board may well prove to constitute such a narrow class of derivative transactions that they are best regulated through the examination process without applying Section 23A.

3. Additional Proposal By The Board.

The Board has indicated that it intends to issue a detailed proposed rule for public comment with regard to the credit exposure arising from derivative transactions between Banks and their affiliates if, based on its analysis of public comments to the Proposal, the Board believes additional measures are needed. 66 Fed. Reg. at 24197.

With reference to the Board's stated position that government regulation should only be imposed if a demonstrable need for such regulation exists and given the complexity and variances inherent in the derivative transactions identified by the Board as potentially subject to Section 23A, ISDA believes that an additional detailed proposal by the Board would be the most prudent approach. ISDA urges the Board to set forth for public comment in such an additional proposal, those specific derivative transactions between Banks and their affiliates identified by the Board in the examination context as raising concerns under Section 23A. Identification of the specific problems found in the examination process will permit commentators to address the Board's concerns in a more meaningful way than is possible based on the information provided in the release on proposed Regulation W. Perhaps, proposal of a final regulation should await the receipt of comments on a release more specifically addressing the transactions causing the Board concern.

The Board has also solicited public comment on the appropriate definition of the term "derivative transaction." 66 Fed. Reg. at 24195. ISDA is prepared to propose a definition (or, at a minimum, the essential elements of a definition) of "derivative transaction" if the Board publishes an additional proposal for public comment regarding derivative transactions between Banks and their affiliates incorporating a more specific approach. Although ISDA understands the Board's desire to define "derivative transaction" at the outset, ISDA believes that the appropriateness of a particular definition would wholly depend on the Board's treatment of derivative transactions under any additional proposal.

II. Intraday Extensions of Credit.

ISDA endorses the Board's treatment of intraday extensions of credit by Banks to their affiliates as set forth in the Proposal. ISDA views the Board's treatment of such intraday extensions of credit as consistent with the Board's long-standing position that a regulatory burden should only be imposed where there is a demonstrable need for government regulation.

ISDA agrees with the Board's view that intraday overdrafts and other forms of intraday credit extensions are generally not used by Banks as a means of funding or otherwise providing financial support to an affiliate. Rather, these credit extensions typically facilitate the settlement of transactions between an affiliate and its customers when there are mismatches between the timing of funds sent and received during the business day. 66 Fed. Reg. at 24232. Although some risk exists that such intraday credit extensions could turn into overnight funding of an affiliate, ISDA believes that the risk is sufficiently remote that application of the strict collateral and other requirements of Section 23A would not be warranted for the intraday credit exposure.

ISDA further shares the Board's concern that if the Board mandated that Banks collateralize intraday exposures, such a requirement could force Banks to measure exposures across multiple accounts, offices and systems on a global basis and to adjust collateral holdings in real time throughout the day. *Id.* Few Banks currently have these capabilities and it would be prohibitively expensive to implement them. Moreover, the expense would be completely unjustifiable given the absence of evidence of an underlying problem to be addressed.

III. The "Readily Identifiable and Publicly Available Market Quotation" Exemption.

ISDA is of the view that this exemption from the quantitative restrictions under Section 23A should be expanded and ISDA therefore urges the Board to amend its final rule in this regard. First, the exemption should not be limited to purchases from U.S. broker dealers that are registered with the Securities and Exchange Commission. Second, ISDA respectfully submits that it would be appropriate to use independent third party dealer quotations to establish a market price for a security under this exemption. In this regard, the Board's staff has opined that the standard for the exemption would be met if the price of the security were substantiated by quotations appearing in a widely disseminated news source such as the *Wall Street Journal*.⁶ The Board expanded this standard in the Proposal to "electronic services that provide indicative data from real-time financial networks". The logic of the Board's position to date therefore suggests that it would be equally appropriate to utilize independent third party dealer quotations to establish a market price for a security, as third party dealer quotations provide objective validation of the price of such security. Third, ISDA believes that a Bank should be allowed under the exemption to purchase publicly quoted asset-backed securities issued by an affiliate of the Bank or to purchase securities issued by a publicly quoted mutual fund advised by the Bank or an affiliate of the Bank. The existence of public market quotations for these securities eliminates the opportunity for abusive transactions and the need for application of Section 23A.

⁶ SR 98-6 (SPE), *Section 20 Subsidiaries – Impact on Inspections Resulting From the Replacement of "Firewalls" with Operating Standards* (March 27, 1998).

Similarly, due to Banks' need to hedge derivatives, ISDA urges the Board to expand this exemption to permit the acquisition of investment-grade assets from affiliates for hedging purposes.

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ISDA appreciates the opportunity to comment on the Proposal and would be pleased to discuss any of the points made herein in more detail. Should you have any questions, please contact Stacy Carey, Policy Director, at (212) 332-1202.

Sincerely,

A handwritten signature in black ink, appearing to read "Keith Bailey". The signature is written in a cursive style with a prominent flourish at the end.

Keith A. Bailey
Chairman