BANK FOR INTERNATIONAL SETTLEMENTS

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By TNT

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18 March 2011

In Re: Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr Radhakrishnan and Mr Brigagliano,

The Bank for International Settlements ("**BIS**") supports the introduction of mandatory central clearing requirements 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. While markets in certain OTC derivatives asset classes continued to function well throughout the crisis, the crisis demonstrated the potential for contagion arising from the interconnectedness of OTC derivative market participants and the limited transparency of counterparty relationships. The Pittsburgh (September 2009) and Toronto (June 2010) G20 recommendations emphasise the importance of central clearing of OTC derivatives as a policy response to the crisis. In that context, the BIS recognises the importance of the implementation of Title VII of the Dodd-Frank Act (the "**Act**") and wishes to express its appreciation for the significant role that the Commodity Futures Trading Commission (the "**CFTC**") and the Securities and Exchange Commission (the "**SEC**" and, together with the CFTC, the "**Commissions**") are playing in addressing this issue.

The use of OTC derivatives by international financial organisations such as the BIS is not specifically addressed in Title VII of the Act. As we describe further below, the BIS plays a unique role in the international financial system, essentially serving as a bank for central banks and international public entities. In order to fulfil this public mission, the BIS is not subject to national-level

regulatory supervision. In connection with the banking services it provides, it enters into a limited range of OTC derivatives transactions with financial counterparties. Due to the BIS's very high credit quality, such transactions pose no risk to systemic stability. Yet, unless clarified, the Act could apply to the BIS and its transactions, impacting the BIS's ability to perform its unique function. This would not be consistent with the treatment of international public organisations such as the BIS under proposed legislation in this area in the European Union.[1] Therefore, we request that the Commissions use their definitional authority under the Act to clarify the definitions of "swap" and "security-based swap," as used in the Commodity Exchange Act and Securities Exchange Act of 1934, respectively, to exclude any agreement, contract, or transaction a counterparty of which is an international public organisation, such as the Bank for International Settlements.

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

Bank for Central Banks. As the Commissions are aware, 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 56 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.[2] Rather, under its founding documents,[3] the activities of the BIS are to be overseen by its Board of Directors, currently composed of 19 governors and deputy governors of central banks, and the Board has in turn established a number of committees to assist it in this regard.[4]

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[1] See footnote 11 below.

[2] Hague Convention respecting the Bank for International Settlements (20 January 1930).

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

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

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.[5]

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 and could, depending on the requirements of the central banks concerned, be conducted using currency swaps. Related hedging of such exposures 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.[6] 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.[7] 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 capital adequacy framework,[8] which is consistent with that assigned to the

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[5] The fair value of BIS collateralised derivative transactions at the end of September 2010 was SDR 2.75bn (USD 4.3bn). Collateral held in relation to these transactions was SDR 2.8bn (USD 4.4bn).

[6] 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.

[7] At the end of September 2010, BIS shareholders' equity was SDR 16.3bn (USD 25.2bn). The Bank's Tier 1 ratio, consistent with the Basel II framework, was 55.6%.

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

highest quality sovereign and supranational entities. The same risk weighting for the BIS has also been proposed by the relevant US authorities.[9]

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.

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. While the definitions do exclude "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," there is no express exclusion in the statute for international public organisations like the BIS.

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 or the liquidity available for the discharge of their functions at times of financial market stress should not be threatened. Implementation should further avoid the imposition of national regulatory supervisory requirements on international public organisations. Yet, the application of Title VII to the BIS's OTC derivatives activities with United States counterparties would risk doing just that. Central clearing of the BIS's OTC derivatives could also 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 to submit its trades to clearing via a clearing broker could threaten the confidentiality required by the BIS's central bank clients and impair its operational capability.

Anticipating that many situations would need to be addressed by regulators in the rulemaking process, Congress vested the Commissions with the rulemaking authority to further define certain terms, including "swap" and "security-based swap."[10] The Commissions should use this authority to clarify that these terms also exclude any agreement, contract, or transaction a counterparty of which is an international public organisation, such as the Bank for International Settlements. Identical considerations supported the framing of proposed legislation in this area in the European Union.[11] In such circumstances, the Commissions may

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[9] 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).

[10] *See* Dodd-Frank Act § 721(b) ("The [CFTC] may adopt a rule to define—(1) the term "commercial risk"; and (2) any other term included in an amendment to the [CEA] . . . ."). Section 761(b) of the Dodd-Frank Act provides similar definitional authority to the SEC and allows the SEC to, "by rule, further define" any term included by the Dodd-Frank Act in the Exchange Act.

[11] The special position and mission of central banks and international institutions such as the BIS has been recognized in the current draft of the proposed EU Regulation on Central Clearing of OTC Derivatives. See further at
http://register.consilium.europa.eu/pdf/en/11/st05/st05059.en11.pdf; Article 1.

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appropriately consider[12] rendering the treatment under the Act of international public organisations like the BIS consistent with their treatment under other global regulatory standards.[13] To conclude, the BIS once again expresses its appreciation for the work of the Commissions in this area, and would be pleased to provide any further information that you might require regarding the matters addressed in this letter.

Yours faithfully

BANK FOR INTERNATIONAL SETTLEMENTS

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[12] See further footnote 11. Under the Act, the CFTC, SEC and Federal Reserve, as appropriate, are directed to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation . . . of swaps [and] security-based swaps . . . ." CEA § 752(a).

[13] The means to procure such parity of treatment would be available by means of a definition of the terms "swap" and "security-based swap" to exclude contracts entered into by appropriate international public bodies, such as those listed in Article 1 of the EU's proposed Regulation.