FS Regulatory Brief

Swaps Pushout: FBOs get needed relief – Level playing field for foreign banks

June 2013

Overview

On June 5, 2013, the Federal Reserve Board (Fed) approved an interim final rule (with request for comment by August 4, 2013) on the treatment of uninsured US branches and agencies of foreign banks under section 716 of the Dodd-Frank Act – the so-called Swaps Pushout rule. Effective immediately, the interim final rule treats uninsured US branches and agencies of foreign banking organizations (FBO branches and agencies) the same as US insured depository institutions (IDIs) under Section 716. This means FBO branches and agencies will benefit from the same exemptions, transition periods and grandfathering provisions in Section 716 for IDIs.

It is not clear why it took the Fed almost three years to arrive at this result (only after the OCC provided relief to the US banks), especially given that the disparate treatment was widely viewed as a legislative drafting error that the regulators were inevitably going to have to resolve through interpretation – and not by relying on a legislative fix through the political process. It was a long period of limbo for the FBOs – too long in fact – with the Swaps Pushout requirements becoming effective on July 16, 2013.[1] At least in the end, justice delayed is not justice denied.

[1] See Guidance on the Effective Date of Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 77 Fed. Reg.27465 (May 10, 2012).

[2] Under Section 716 and the Fed's rule, a" swaps entity" means any person registered as a swap dealer, security-based swap dealer, major swap participant (MSP) or security-based MSP, other than an IDI registered as a MSP or security-based MSP.

FBO branches and agencies that are or will become swaps entities[2] by July 16, 2013, and that engage in derivatives activities equally prohibited for IDIs, will want to apply under the new rule for a compliance transition period of up to 24 months from July 16, 2013, which can later be extended for an additional year, to allow them to conform their activities over time. For those FBO branches and agencies that become swaps entities after July 16, 2013, they can apply for a two-year transition from the date on which they become a swaps entity, which also can be extended for another year. The Fed stated that it would seek to act on a request for a transition period "expeditiously." The Fed's interim rule also allows state member banks to apply for a transition period, since the Fed is the primary regulator of state member banks in addition to state-licensed FBO branches and agencies.

A controversial rule

Section 716 took a unique approach to regulating swaps entities that were also banking institutions with access to the Fed's discount window or that had FDIC insurance or guarantees – they would lose that access or insurance if they did not pushout certain swaps activities from their bank. This Hobson's Choice was ameliorated somewhat for IDIs by exempting most traditional bank swaps activities from the prohibitions, by providing a transition period of two (and possibly three) years, and by grandfathering from the prohibitions those swaps entered into before the end of the transition period. However, the way that the Swaps Pushout was drafted failed to specifically address the situation of FBO branches and agencies, leaving them in a grey area that appeared to put them at a distinct disadvantage to IDIs.

In the interim rule the Fed has addressed the interpretive – and equal treatment – issues by simply defining an IDI for purposes of Section 716 to include an FBO branch or agency of a foreign bank. It does so in Talmudic fashion by determining that there is no definition of IDI in Section 716; that provisions of federal banking law providing that the Federal banking agencies may enforce compliance on FBO branches and agencies are based on their treatment as IDIs; and that both insured and uninsured branches and agencies may receive Fed advances from its discount window on the same terms and conditions as IDIs. This is an elegant solution that allows Section 716 to be applied consistently to both IDIs and FBO branches and agencies of foreign banks without need for a technical legislative amendment – which would be politically untenable to accomplish by July 16, 2013.[3] While to the best of our knowledge, there has been no political opposition to providing equal treatment of FBO branches and agencies, Section 716 still has a number of supporters in Congress who view it as a key piece of Dodd-Frank aimed at Wall Street.

The equal treatment created by the interim rule not only opens up the possibility for FBO branches and agencies to be granted a transition period (and subsequent extension), but also levels the permissible Section 716 product scope playing field to include swaps used to hedge or mitigate risk, interest rate swaps and swaps that reference currencies, bullion metals, loans or bank-eligible debt securities other than uncleared credit default swaps. While no banking institution likes the Swaps Pushout rule, at least institutions that have to comply will be playing by the same rules.

Request for a transition period

State-licensed FBO branches and agencies and state member banks will need to submit a written request to the Fed in order to take advantage of the transition period. The application must include:

- The length of the transition period requested;
- A description of the impact that immediate divestiture or cessation of swap activity would have on the institution's mortgage lending, small business lending, job creation and capital formation versus the potential negative impact on insured depositors and the Deposit Insurance Fund of the FDIC; and
- A description of the institution's plan for conforming its activities to the requirements of Section 716.

The Fed may also request any other information that it believes appropriate to respond to the request.

Earlier this year, the Office of the Comptroller of the Currency (OCC) issued formal guidance notifying insured national banks, Federal Savings Associations and insured federal branches, that the OCC was prepared to "consider favorably" requests for a transition period under Section 716. Requests had to be submitted by January 31, 2013. While a number of requests were filed, we believe none of these requests have been approved yet. The Fed's interim final rule – by clarifying the treatment of FBO branches and agencies (including uninsured Federal branches of foreign banks) – may be indicative that action on those requests may now be forthcoming. However, because uninsured Federal branches were not covered by the original OCC guidance, the OCC may need to issue additional guidance providing those uninsured federal branches that may need relief with the same opportunity to request a transition period.

[3] Although H.R. 992 has been reported by two House Committees and would provide equal treatment for FBO branches and agencies, it also would limit the Swaps Pushout generally to swaps based on certain asset-backed securities.

What a relief – but there is work still to be done and timing is tight

If they have not done so previously, FBO branches and agencies will need to quickly assess the Section 716 IDI exclusions and exemptions, and interpret the applicability to their current swaps activities. Those FBO branches and agencies that have been preparing to push out traditional bank-related swaps activities, discussed above, may want to reconsider their plans.

If FBO branches and agencies are engaging in swaps activities not exempted by the rule, they will need to immediately begin to prepare their request for a transition period. Based on our experience advising IDIs on completing their transition period requests for the OCC in January, answering the required questions will involve a significant effort over the next several weeks (to hopefully receive the extension request before the July 16th deadline).

Assuming a transition period is granted, both IDIs and FBO branches and agencies will have the opportunity to re-evaluate their optimal US facing legal entity by conducting an objective (qualitative and quantitative) assessment of their operating and booking models. Key drivers for identifying the optimal pushout entity include client acceptance, credit, transition costs, operating synergies and systems impacts, as well as capital, liquidity and funding considerations.

The impact of the Swaps Pushout rule is just one piece of the global regulatory puzzle that global banks have to assess over the next several years – in addition to other drivers of regulatory change, including Dodd-Frank (e.g., the Volcker Rule, derivatives rules, and enhanced prudential supervision including establishing intermediate holding companies), EMIR and Basel III. At least the IDIs and FBO branches and agencies now have an additional two years to determine how to factor the Swaps Pushout rule into their overall US and global strategies for derivatives activities.

Additional information

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