

KfW Bankengruppe, Postfach 111141, 60046 Frankfurt am Main

Via Federal eRulemaking Portal and e-mail

Office of the Comptroller of the
Currency
400 7th Street, S.W., Suite 3E-218
Mail Stop 9W-11
Washington, D.C. 20219
Attention: Legislative and
Regulatory Activities Division
Docket ID OCC-2013-0016
RIN 1557 AD 74

Board of Governors of the
Federal Reserve System
20th Street & Constitution
Avenue, N.W. Washington, D.C.
20551
Attention: Robert de V. Frierson,
Secretary
Docket No. R-1466
RIN 7100-AE03

Federal Deposit Insurance
Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Robert E. Feldman,
Executive Secretary
RIN 3064-AE04

Date: 01/30/2014

»» Re: **Liquidity Coverage Ratio: Liquidity Risk Measurement,
Standards, and Monitoring**

Ladies and Gentlemen:

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We are writing to confirm our understanding that, under the U.S. banking agencies' (together, the "Agencies")¹ proposed rules (the "Proposed Rules")² implementing for certain U.S. banking organizations ("U.S. Covered Banks") the liquidity coverage ratio ("LCR") adopted by the Basel Committee on Banking Supervision (the "Basel Committee") as an international standard,³ KfW would not be considered to be a "regulated financial company".⁴ The term regulated financial company is defined so

¹ The Agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation.

² Notice of Proposed Rulemaking, *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards and Monitoring*, 78 Fed. Reg. 71818 (Nov. 29, 2013).

³ The Basel Committee published the international liquidity standards in December 2010 (*Basel III: International framework for liquidity risk measurement, standards and monitoring* (December 2010)) and revised the standards in January 2013 (*Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (January 2013)) (such revised standards, the "Basel LCR").

⁴ Proposed Rules § 2.

broadly in the Proposed Rules as to create some ambiguity as to whether KfW and other public sector entities, within the meaning of the Basel I capital framework ("PSEs"),⁵ in non-U.S. jurisdictions fall within its scope. Assuming that KfW is not a regulated financial company, its debt securities would qualify as Level 1 high quality liquid assets ("HQLA") under the Proposed Rules. It will be important to U.S. Covered Banks that currently own or may acquire our debt securities as investors, and to KfW as an issuer, to have clarity on this point. We appreciate that clarity as to the status of debt securities of other non-U.S. PSEs under the Proposed Rules, and in that connection the scope of the definition of the term regulated financial company as applied to them, is important as well.

KfW is a government-sponsored entity in the Federal Republic of Germany (the "*Federal Republic*") owned by federal and state authorities, mandated to serve a public purpose, and whose securities are unconditionally guaranteed by the Federal Republic. KfW (i) does not accept deposits from the public, (ii) is not engaged in a conventional commercial banking business, and (iii) is not recognized or treated as a bank but instead is treated as a PSE within the meaning of German and European banking rules and the Basel I capital framework⁶ and is supervised appropriately for its purpose. As such, KfW believes that it is not a regulated financial company under the Proposed Rules.

For further context, we have set forth in Part of this letter a more complete description of KfW and its background. In Part I we discuss in more detail the application of the Proposed Rules to KfW's debt securities.

I. Background on KfW

Legal Status, Ownership and Statutory Guarantee

KfW is a German public law institution (*Anstalt des öffentlichen Rechts*) organized under the Law Concerning KfW (*Gesetz über die Kreditanstalt für Wiederaufbau*, or "*KfW Law*"). The Federal Republic holds

⁵ Basel Committee, *International Convergence of Capital Measurement and Capital Standards – A Revised Framework Comprehensive Version* (June 2006) (the "*Basel I capital framework*"). The Basel I capital framework provides that claims on certain domestic PSEs may also be treated as claims on the sovereigns in whose jurisdictions the PSEs are established. *Id.* at ¶ 58. We are using the term public sector entity, or "*PSE*", in this letter to mean the Basel I definition of the term, which encompasses non-commercial undertakings owned by governments such as KfW, because the Proposed Rules include a definition of the term that is limited to "a state, local authority, or other governmental subdivision below the sovereign entity level." The Agencies comment on their definition and its relevance to Level 2A HQLA treatment in the preamble to the Proposed Rules, at 71827, but do not appear to use the term within the text of the Proposed Rules.

⁶ Article 4(1)(8) of Regulation (EU) No. 575/2013 (Capital Requirements Regulation, or "*CRR*"); Basel I capital framework, paragraph 53 in conjunction with paragraph 58 and footnote 23.

80% of KfW's subscribed capital and the German federal states hold the remaining 20%.

The KfW Law expressly provides that the Federal Republic guarantees all existing and future obligations of KfW in respect of moneys borrowed, bonds and notes issued and derivative transactions entered into by KfW (KfW Law, Article 1a). Under this statutory guarantee (the "*Guarantee of the Federal Republic*"), if KfW fails to make any payment of principal or interest or any other amount required to be paid with respect to any of KfW's obligations mentioned in the preceding sentence, the Federal Republic will be liable at all times for that payment as and when it becomes due and payable. The Federal Republic's obligation under the Guarantee of the Federal Republic ranks equally, without any preference, with all of its other present and future unsecured and unsubordinated indebtedness. Creditors who have a claim against KfW resulting from one of the obligations mentioned in the first sentence of this paragraph may enforce this obligation directly against the Federal Republic without first having to take legal action against KfW. Against this background, these obligations of KfW, both financially and in terms of legal recourse, are viewed as sovereign credits and KfW's obligations, like those of the Federal Republic, are rated triple A by Moody's, Standard Poors and Fitch.

Furthermore, as a public law institution, KfW benefits from the German administrative law principle of *Anstaltslast*, according to which the Federal Republic, as the constituting body of KfW, has an obligation to safeguard KfW's economic basis. Under *Anstaltslast*, the Federal Republic must keep KfW in a position to pursue its operations and enable it, in the event of financial difficulties, through the allocation of funds or in some other appropriate manner, to meet its obligations when due. Although *Anstaltslast* is not a formal guarantee of KfW's obligations by the Federal Republic, the effect of this legal principle is that KfW's obligations are fully backed by the credit of the Federal Republic on this basis as well, in addition to the Guarantee of the Federal Republic referred to above.

Purpose

KfW was established in 1948 by the Administration of the Combined Economic Area, the immediate predecessor of the Federal Republic. Originally, KfW's purpose was to distribute and lend funds of the European Recovery Program, which is also known as the Marshall Plan. Even today, several of KfW's programs to promote the German and European economies are supported using funds for subsidizing interest rates from the so-called "*ERP Special Fund*". Over the past decades, KfW has expanded and internationalized its operations. Today, KfW serves domestic and international public policy objectives of the German Federal government, primarily by engaging in various promotional lending activities.

KfW does not seek to maximize profits and is prohibited from distributing profits, which are instead allocated to statutory and special reserves. KfW is generally also prohibited from taking deposits, conducting current account business or dealing in securities for the account of others.

Governance and Supervision

KfW is governed by an Executive Board (*Vorstand*) and a Board of Supervisory Directors (*Verwaltungsrat*). The Executive Board is responsible for the day-to-day conduct of KfW's business and the administration of its assets. The Board of Supervisory Directors, which, among others, consists of seven Federal ministers, supervises the overall conduct of KfW's business and the administration of its assets.

Under the KfW Law, the Federal Ministry of Finance, in consultation with the Federal Ministry for Economic Affairs and Energy, supervises KfW and has the power to adopt all measures necessary to safeguard the compliance of KfW's business operations with applicable laws, KfW's by-laws and other regulations (*Rechtsaufsicht*, legal supervision).

In addition to the annual audit of its financial statements, KfW, as a government-owned entity, is subject to an audit that meets the requirements of the Budgeting and Accounting Act (*Haushaltsgrundsatzgesetz*). One of the specific aspects to be covered by this audit and the related reporting is the proper conduct of KfW's business by its management.

KfW is not recognized or treated as a bank in accordance with Section 2(1), No. 2, of the German Banking Act (*Gesetz über das Kreditwesen*, or "KWG") and is exempted from European Union bank regulatory requirements in accordance with Article 2 Paragraph 5(6) of the European Banking Directive 2013/36/EU. However, amendments to the KfW Law enacted in July 2013 and implemented by a regulation published in October 2013 (the "*KfW Regulation*") subject KfW by analogy to such provisions of European and German bank regulatory law as are expressly listed in the regulation, in particular provisions of the KWG and the CRR. The KfW Regulation also provides for supervision of KfW's compliance with the applicable provisions of bank regulatory law by the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) in cooperation with the German Central Bank (*Deutsche Bundesbank*). With respect to its compliance with all other applicable law, KfW remains under the legal supervision (*Rechtsaufsicht*) of the Federal Ministry of Finance, as described above.

Funding Activities

KfW finances the majority of its lending activities from funds raised by it in the international financial markets. KfW issues debt instruments in various currencies, primarily the Euro and the U.S. dollar (which accounted for 48% and 39% of KfW's new capital-market funding in 2013, respectively). As of December 31, 2012, the amount of outstanding bonds and notes issued by KfW totaled EUR 388.0 billion. On the basis of a no-action letter issued by the U.S. Securities and Exchange Commission ("SEC") on September 21, 1987, KfW has registered debt securities with

the SEC under Schedule B of the Securities Act of 1933, which is applicable to foreign governments or political subdivisions thereof.⁷ Since 1987, KfW has offered registered debt securities in global debt offerings in an aggregate amount equivalent to more than EUR 350 billion. As of December 31, 2012 more than 50% of KfW's funded debt outstanding consisted of debt securities sold in these global debt offerings.

II. Discussion

As noted in the introductory paragraphs to this letter, provided that KfW is not considered to be a regulated financial company, its debt securities would qualify as Level 1 HQLA under the Proposed Rules. They are (i) "unconditionally guaranteed as to the timely payment of principal and interest by . . . a sovereign entity",⁸ (ii) "assigned a 0 percent risk weight under sub-part D of" the Agencies' capital regulations,⁹ and (iii), we believe, "liquid and readily-marketable" and "have a proven record as a reliable source of liquidity in repurchase or sales markets during stress markets conditions."¹⁰ However, if KfW were to be considered a regulated financial company under the Proposed Rules, its debt securities would not qualify as Level 1 HQLA notwithstanding their 0 percent risk weight and the Guarantee of the Federal Republic.

The Agencies' approach is conceptually similar to the Basel Committee's approach in paragraphs 50-52 of the Basel LCR. Those paragraphs exclude from Level 1 and Level 2 eligibility obligations of any "financial institution or any of its affiliated entities."

KfW is a PSE and not a "financial institution" under the Basel II capital framework and, accordingly, its obligations would not be excluded as those of "a financial institution" under paragraph 50(c) of the Basel LCR.

⁷ Similarly, the SEC and the Commodity Futures Trading Commission (the "CFTC"), in their May 2012 release adopting new rules and interpretive guidance to further define the major participant definitions under the Commodity Exchange Act and the Securities Exchange Act of 1934, noted in a footnote to the preamble that those agencies consider the term "*foreign government*" to include KfW. 77 Fed. Reg. 30596, 30692, footnote 1178 (May 23, 2012).

⁸ Proposed Rules § 20(a)(5). The Guarantee of the Federal Republic, described in Part , should satisfy this criterion.

⁹ Proposed Rules § 20(a)(5)(i). The Agencies' recently adopted new capital rules, implementing the Basel III capital framework in the United States and published in the Federal Register on October 11, 2013, 78 Fed. Reg. 62018, provide that a "sovereign exposure" (which is defined as "[a] direct exposure to a sovereign" or "an exposure directly and unconditionally backed by the full faith and credit of the sovereign") is 0% risk-weighted if the sovereign is a member of the Organization for Economic Cooperation and Development ("OECD") and the OECD has not assigned a country risk classification to the sovereign. KfW meets those tests.

¹⁰ Proposed Rules § 20(a)(5)(ii)-(iii).

In the preamble to the Proposed Rules, the Agencies comment on the term regulated financial company and the exclusion of their obligations from HQLA status, stating that:

“[a]ssets that are included in HQLA should not be issued by financial sector entities since they would then be correlated with covered companies (or wrong-way risk assets).”¹¹

The Basel LCR also points to wrong-way risk as the reason for excluding obligations of financial institutions from HQLA status.¹² Implicit in both the Agencies’ and the Basel Committee’s focus on wrong-way risk and exclusions for categories of government entities (albeit different in the Proposed Rules and in the Basel LCR) is the recognition that certain categories of government entities are much less likely to raise wrong-way risk concerns than are banks.

First, we strongly believe that our debt securities do not present wrong-way risk concerns. As a government-owned non-profit PSE, mandated to serve a public purpose and whose debt securities are backed by the Guarantee of the Federal Republic, the credit risk content of KfW debt securities is that of the Federal Republic’s government bonds, not that of securities of banks.

Second, as to the definition itself, the term regulated financial company is defined through seven paragraphs that specify types of entities that are regulated financial companies and an eighth paragraph that excludes from regulated financial company status certain specified types of entities, including U.S. government-sponsored enterprises¹³, but does not exclude from regulated financial company status non-U.S. PSEs or government-sponsored enterprises. In the preamble to the Proposed Rules, the Agencies note the exclusion of U.S. government-sponsored enterprises from regulated financial company status¹⁴ but do not comment on the reasoning behind the exclusion. Presumably the exclusion rests on the Agencies’ belief that securities of U.S. government-sponsored enterprises do not raise wrong-way risk concerns that warrant treating such enterprises as regulated financial companies.

¹¹ 78 Fed. Reg. at 71824.

¹² The Basel LCR ¶ 24(i), in describing the fundamental characteristics of HQLA, notes:

“**low correlation with risky assets:** the stock of HQLA should not be subject to wrong-way (highly correlated) risk. For example, assets issued by financial institutions are more likely to be illiquid in times of liquidity stress in the banking sector.”

¹³ That term itself is a defined term covering “an entity established or chartered by the Federal government to serve public purposes specified by the United States Congress, but whose debt obligations are not expressly guaranteed by the full faith and credit of the United States government.”

¹⁴ 78 Fed. Reg. at 71824, footnote 24.

The paragraph in the definition of regulated financial company that concerns us, as applied to KfW, is paragraph (7), which brings within the scope of the definition

“[a]ny company not domiciled in the United States . . . that is supervised and regulated in a manner similar to entities described in paragraphs (1) through (6) of this definition (e.g., a foreign banking organization).”¹⁵

Its use of the phrase “supervised in a manner similar to” the entities described in the earlier paragraphs of the definition, which include traditional banks and their holding companies, is a broad concept that could be subject to a variety of interpretations. KfW, like virtually any PSE or government-sponsored enterprise that has financial functions or some bank-like operations (whether inside or outside of the United States), is subject to some regulation.

KfW, as described in Part I, is not recognized or treated as a bank under European and German banking law and the Basel I capital framework. However, KfW is subject to certain provisions of European and German bank regulatory law – capital requirements, for example. Given the limited nature of its business, it is not subject to others – for example, regulations applicable to deposit-taking activities.

We strongly believe that KfW and, for that matter, other PSEs outside of the United States that were established for a public purpose and are not engaged in the full scope of a traditional banking business do not create wrong-way risk of the type addressed by the Agencies in the preamble to the Proposed Rules. Accordingly, such non-U.S. PSEs, like U.S. government-sponsored enterprises, should not be treated as regulated financial companies for purposes of the LCR as ultimately implemented for U.S. Covered Banks. Securities of non-U.S. PSEs that satisfy the other requirements for all HQLA in Section 20 of the Proposed Rules should be recognized as HQLA. As noted above, the Basel LCR does recognize such securities as HQLA.¹⁶ Moreover, given the narrow scope of HQLA under the LCR in all jurisdictions (including the United States), it is important that the Agencies not exclude categories and obligations from HQLA status inadvertently. As to the Basel LCR, securities of KfW qualify as HQLA according to paragraph 50(c).

¹⁵ The other paragraphs in the definition on their face would not apply. For example, KfW does not have a branch, agency or subsidiary (banking or otherwise) in (or operating in) the United States and is not a bank holding company, foreign bank or foreign banking organization subject to regulation in the United States or a company of any of the other types referred to in paragraphs (1) through (6). With respect to paragraph (3)'s use of the term “foreign bank”, the Federal Reserve's Regulation K, in Section 211.2(j), defines the term foreign bank to mean an entity that, among other things, “receives deposits to a substantial extent in the regular course of its business.” KfW does not meet that test.

¹⁶ See note 11 and the related text.

Assuming that the Agencies agree with our view that KfW and, again, other similarly situated non-U.S. PSEs are not regulated financial companies, we respectfully request that the Agencies, when they adopt final rules (the "*Final Rules*") implementing the LCR for U.S. Covered Banks, address this issue through one or more of three approaches. The first approach would be to further explain, in the preamble to the Final Rules, how paragraph (7)'s "supervised and regulated in a manner similar" standard should be construed. Were the Agencies to adopt that approach, they could do so by specifying that KfW and other non-U.S. PSEs that are owned by sovereign and other governmental authorities and mandated to serve a public purpose are not intended to be captured by paragraph (7), notwithstanding that they may be subject to some degree of supervision and regulation in their respective home countries.

The second approach would be to expressly address the issue, not merely as a matter of clarification of paragraph (7)'s "supervised and regulated in a manner similar" standard, by adding a new clause to paragraph (8) to the definition of regulated financial company expressly excluding an appropriate class of non-U.S. PSEs. This approach would parallel the Proposed Rules' exclusion for U.S. government sponsored enterprises and be consistent with paragraphs 50-52 of the Basel LCR. The Agencies could implement that approach by adding an exclusion for "*non-U.S. public sector entities*" and including a definition for that term reading as follows:

"Non-U.S. public sector entity means an entity that is a public sector entity within the meaning of the Basel II capital framework and that was established or chartered by a sovereign government outside of the United States to serve a public purpose or purposes specified in the charter (whether a statute or otherwise) for such entity."¹⁷

The standard suggested in the definition – a non U.S. public sector entity established or chartered by a sovereign government outside of the United States to serve a public purpose or purposes – is consistent with the Proposed Rules' definition of "*U.S. government-sponsored enterprise*".

¹⁷ We are using the phrase "*public sector entity*" instead of "*government-sponsored enterprise*" in the suggested definition in order to avoid confusion both with (i) the terms that the Agencies historically have used in their risk-based capital calculations, where the term government-sponsored enterprise is consistently used to mean an entity established or chartered for a public purpose but whose debt obligations are not expressly guaranteed by the U.S. government, and the term U.S. government agency is consistently used to mean an instrumentality of the U.S. government whose obligations are fully and explicitly guaranteed and (ii) the term public sector entity as defined in the Proposed Rules (discussed in footnote 5 to this letter). If the Agencies adopt our suggestion, they will need, as a drafting matter, to include a definition of the "*Basel II capital framework*", either within the new definition of "*Non-U.S. public sector entity*" or as a separate definition.

The third approach would be to respond to our concern more narrowly, addressing only KfW and not other non-U.S. PSEs. The Agencies might adopt this approach if they conclude, as we believe (and consistent with KfW's purpose, history, activities and German-government guaranteed funding), that KfW does not present the type of wrong-way risk concern that the definition of regulated financial company is meant to encompass but are not comfortable at this point in enunciating a general standard that might apply to other non-U.S. PSEs. If the Agencies were to adopt this approach, they could do so by including a footnote attached to the relevant text in the preamble to the Final Rules, similar to the CFTC's approach in its May 2012 release referenced in footnote 7 to this letter. The footnote or other text in the preamble to the Final Rules could simply confirm that the Agencies do not consider the term regulated financial company to include KfW, and then, like the CFTC's approach and perhaps with the same description, describe KfW – i.e., "which is a non-profit, public sector entity responsible to and owned by the federal and state authorities in Germany, mandated to serve a public purpose, and backed by an explicit, full, statutory guarantee provided by the German federal government."

* * *

Thank you for your consideration of our comments and please do not hesitate to contact Mark J. Welshimer of Sullivan & Cromwell LLP (Telephone: 212-558-3669; E-mail: welshimerm@sullcrom.com) if you have questions or would find further background helpful. We have sent a copy of this letter to the Federal Ministry of Finance of Germany in its capacity as KfW's owner and in its capacity as KfW's legal supervisory authority.

Sincerely,

KfW



Dr. Lutz-Christian Funke
Senior Vice President



Dr. Frank Czichowski
Senior Vice President and Treasurer