BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

October 17, 2014

Satish M. Kini, Esq.
Debevoise & Plimpton LLP
555 13th Street N.W.
Washington, D.C. 20004

Subject: Request for a transition period under section 716(f) of the Dodd-Frank Act

Dear Mr. Kini:

This responds to the request filed on behalf of Fifth Third Bank ("Fifth Third"), Cincinnati, Ohio, for a transition period under section 716(f) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Fifth Third is an Ohio state-chartered member bank that, upon receiving a transition period from the Board, will complete the steps necessary to become a provisionally registered swap dealer with the Commodity Futures Trading Commission (the "CFTC").

Section 716 of the Dodd-Frank Act generally prohibits the provision of "Federal assistance" to any swaps entity, subject to certain exceptions for insured depository institutions.[1] A swaps entity generally includes any swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant that is registered under the Commodity Exchange Act or the Securities Exchange Act of 1934, as applicable, with certain exceptions.[2]

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[1] *See* 15 U.S.C. § 8305(a). "Federal assistance" is defined in section 716(b)(1) as "the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act, Federal Deposit Insurance Corporation insurance or guarantees. ..." 15 U.S.C. § 8305(b)(1).

[2] *See* 15 U.S.C. § 8305(b)(2).

Section 716(f) provides that the appropriate Federal banking agency "shall permit" an insured depository institution that qualifies as a swaps entity a transition period of up to 24 months to comply with the provisions of section 716. The Board of Governors of the Federal Reserve System (the "Board") is the appropriate Federal banking agency for Fifth Third.[3]

Section 716(f) requires the Board to consult with and consider the views of the CFTC and the Securities and Exchange Commission (the "SEC"), as appropriate, when determining an appropriate transition period.[4]

Background

Section 716 is contained in Title VII of the Dodd-Frank Act, which establishes a comprehensive new regulatory framework for swaps, security-based swaps, and the markets for such instruments. An orderly restructuring of swaps-dealing activities as a result of the application of section 716 is related to and affected by regulatory actions to implement Title VII. Development of the regulatory structure under Title VII is ongoing. Although the Title VII regulatory structure is still in the process of being implemented, section 716 went into effect on July 16, 2013.[5]

In granting a transition period under section 716(f), the Board is required by statute to take into account and make written findings regarding the potential impact of divestiture or cessation of swaps-dealing activities on the insured depository institution's (1) mortgage lending, (2) small business lending, (3) job creation, and (4) capital formation versus the potential negative impact on (1) insured depositors and (2) the Deposit Insurance Fund ("DIF") of the Federal Deposit Insurance Corporation (the "Statutory Factors").[6] The Board may also consider other factors as may be appropriate.[7] The Board has delegated authority to the Director of the Division of Banking Supervision and Regulation ("Director") or his or her designee, in consultation with the General Counsel, to establish a transition period of up to 24 months for institutions requesting transition-period relief.

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[3] *See* 12 U.S.C. § 1813(q)(2).

[4] Board staff consulted with the CFTC and the SEC. Neither agency offered comment on the request.

[5] *See* Guidance on the Effective Date of Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Federal Register 27456 (May 10, 2012).

[6] 15 U.S.C. § 8305(f).

[7] Id.

Consideration of the Statutory Factors and Findings

In establishing the appropriate length of the transition period to effect divestiture or cessation of swaps-dealing activities, the Director has considered the Statutory Factors as well as the extent to which the length of the transition period would affect the potential for operational risk problems and other risks associated with restructuring swaps activities.

As described below, requiring Fifth Third to cease swaps-dealing activities prohibited by section 716 upon becoming a registered swap dealer could pose significant challenges to Fifth Third and its affiliates and to a range of their clients, including mortgage market participants, small businesses, and firms with commercial relationships to small businesses. The cessation of these activities could adversely affect mortgage and small business lending activities, job creation, and capital formation activities without reducing risk to insured depositors or to the DIF.

The Director, in considering the request, has determined that a transition period until October 30, 2015, is appropriate. A transition period until October 30, 2015, will provide Fifth Third with time to conform its impermissible swaps activities, as required by section 716, because the volume of impermissible swaps activities conducted by Fifth Third represents a relatively small portion of its swaps contracts and because Fifth Third has been on notice regarding the prohibitions on swaps-dealing activities under section 716 since it became effective on July 16, 2013. If Fifth Third is unable to conform its swaps activities to section 716 by October 30, 2015, the bank would be able to request an extension of the transition period for a period of up to one additional year.

Mortgage Lending.

Fifth Third engages in a significant amount of mortgage lending and, therefore, a cessation of its existing swaps activities or divestiture or termination of its existing swaps positions could decrease Fifth Third's mortgage activities or cause delays for mortgage applicants. Near-term cessation or divestiture of Fifth Third's swaps activities may increase operational risk. Operational and legal risks may potentially arise from the need to novate contracts from Fifth Third to its affiliates, especially where questions regarding the regulation and structure of such entities to which the contracts would be novated remain unresolved. These include both the potential for errors that could lead to enforceability issues under normal circumstances and, in the case of a credit event, to complications related to netting of contracts and calculation of closeout values. Of note, these risks would in practice be borne by both Fifth Third and its clients.

Divestiture or cessation of Fifth Third's swaps activities in the short run may also pose challenges to the bank's clients who are active in the mortgage market as investors, servicers, and originators to the extent that it could complicate the routine implementation of risk-management strategies. As a consequence, counterparties could more quickly run up against their limits on counterparty exposure to Fifth Third and its affiliates, which would likely raise the cost of mortgage lending or lead to a reduction in the amount of mortgage lending.

A transition period until October 30, 2015, could significantly mitigate operational risk and provide reasonable time for Fifth Third to develop and implement an orderly transition plan. Lower operational risk, in turn, decreases the probability that cessation of Fifth Third's swaps activities would adversely affect mortgage lending.

Small Business Lending.

Consistent with the effects on mortgage lending, near-term cessation or divestiture of Fifth Third's swaps may pose operational risks that could affect small business lending conducted by Fifth Third. Operational problems in the swaps market in general could also have a negative effect on small business lending.

A transition period until October 30, 2015, could mitigate these risks and, therefore, mitigate the risk of a financial market disruption that could impair small business lending. Lower risk, in turn, could decrease the probability of a financial market disruption that could adversely affect small business lending.

Job Creation.

In evaluating the effects of divestiture or cessation of swaps dealing on job creation, the Director has considered the direct relationship between immediate cessation of derivatives activities and the loss of revenues and jobs.

The near-term cessation or divestiture of Fifth Third's swaps dealings has the potential to result in job losses if the bank reduces its lending and financial intermediation activities.

A transition period until October 30, 2015, could mitigate the potential for general market disruptions, including disruptions to credit and capital markets that could weaken job growth and have other negative macroeconomic consequences.

Capital Formation.

In evaluating the effects of divestiture or cessation of swaps dealing on capital formation at Fifth Third, the Director has considered, among other things, lending activities, the loss of netting efficiencies, and costs associated with the modification of business practices and compliance procedures.

Operational and reputational risk problems at Fifth Third may prevent the bank from engaging in its core lending activities and, thus, may limit capital formation. Abrupt cessation could also adversely affect capital formation, including through a reduction in lending and risk mitigation, which could cause a decline in economic activity, and through decreased swap netting efficiencies that would require clients to hold more capital.

A transition period until October 30, 2015, could mitigate the potential for capital market disruptions. Thus, by granting a sufficient transition period, risks to individual financial institutions and to the banking system as a whole would be decreased. The benefit of mitigating the risk of capital market disruption favors granting a transition period until October 30, 2015 to Fifth Third.

Other Factors.

As permitted by section 716, the Director has also considered other potential effects of requiring immediate conformance with section 716. Compliance with section 716 will require an insured depository institution, such as Fifth Third, to (1) determine whether to terminate its swaps activities or transfer them to a third party or an affiliate; (2) identify and capitalize an affiliate, if appropriate, to accept the swaps; and (3) novate existing swaps to the affiliate. Terminating or novating existing swaps will require the parties to negotiate and enter into new or modified swap arrangements, which could change the parties' exposure with respect to the swaps. New agreements or modifications to existing agreements may require the parties to adjust related transactions, including existing hedges. If an insured depository institution were required to divest or cease these swaps activities in a short time period, it may lead to a disorderly and inefficient unwinding that could present operational and risk-management risks for both the insured depository institution and its counterparties. These modifications could be complicated by the fact that they would occur simultaneously with many regulatory and structural market changes.

Insured Depositors.

Insured depositors are protected from risk of loss during the transition period up to the current standard maximum deposit insurance amount of $250,000. The Director has concluded that a transition period until October 30, 2015, would be less likely to negatively affect insured depositors than a shorter transition period because an orderly restructuring of Fifth Third's swaps dealing over that period of time would be less likely to have a negative effect on the financial health of Fifth Third than would the quick cessation of swaps activities.

Moreover, Fifth Third is subject to regulatory and other requirements designed to require the bank to conduct its swaps activities in a safe and sound manner. Fifth Third would remain subject to examination to verify its conformance with those requirements. The regulatory framework mitigates the risk from conduct of affected derivatives activities during the transition period.

The Deposit Insurance Fund (DIF).

The DIF bears the risks associated with resolving an insured depository institution that has failed because of problems related to its swaps dealing. This risk includes payouts from the DIF to insured depositors of the institution. The Director has decided that it is also necessary to consider the risks to the DIF that could result from potential market disruptions under a scenario with an inadequate transition period. For the reasons explained above, an orderly restructuring of Fifth Third's swaps dealing poses less risk to the DIF than if the bank were required to cease or divest its swaps dealing without a sufficient transition period. Although swaps dealing does have inherent risks, the operational, reputational, and other risks to Fifth Third of a requirement for an immediate cessation or divestiture, as discussed above, are more likely to cause market disruptions that threaten the DIF. Moreover, as noted above, Fifth Third is required to conduct affected derivatives activities in a safe and sound manner during the transition period. On balance, the Director has concluded that avoiding potential market disruptions and the negative effects they could have on the DIF support a transition period until October 30, 2015, for Fifth Third.

Conclusion

As set out above, the Director has evaluated the impact of divestiture or cessation of Fifth Third's swaps dealing on mortgage lending, small business lending, job creation, and capital formation versus the potential negative impact on insured depositors and the DIF in determining the appropriate length of the transition period. Overall, the Director has determined that the potential impact of granting a transition period until October 30, 2015, is less adverse than the potential impact of denying the transition period or providing a shorter transition period. The lesser impact associated with a transition period until October 30, 2015, results from lowering the probability of operational problems and market disruption that could occur if Fifth Third does not have a sufficient opportunity to restructure its swaps dealing in an orderly manner.

The transition period until October 30, 2015, would permit Fifth Third to better evaluate whether to transfer the swaps activities to a third party or an affiliate(s) and which affiliate(s) is best positioned to accept its swaps business. The transition period until October 30, 2015, also would permit the creation of a new affiliate(s) and appropriate capital planning for any affiliate that assumes swaps activities. This transition period would also allow Fifth Third to evaluate its decisions in the context of further development of the regulatory requirements of Title VII.

In contrast, no transition period or a shorter transition period could result in disorderly termination or divestiture of swaps activities and considerable disruption to swaps markets and financial markets that could weaken lending markets and result in a similar negative impact on job creation and capital formation.

After considering the written findings set forth above, and after consulting with the CFTC and the SEC, the Director, in consultation with the General Counsel, acting pursuant to delegated authority, has determined to establish a transition period until October 30, 2015, under section 716(f) for Fifth Third.

This approval is conditioned on the facts and representations set forth in Fifth Third's correspondence. These representations are deemed to be conditions imposed in writing by the Board in connection with the findings and decision herein and, as such, may be enforced in proceedings under applicable law. Any change in the facts and representations presented could result in a different conclusion and should be reported to Board staff immediately.

If you have any questions concerning this letter, please contact Victoria Szybillo, Counsel, at (202) 475-6325, or Michelle Kidd, Counsel, at (202) 736-5554, both of the Board's Legal Division.

Sincerely yours,

Margaret M Shanks

Margaret McCloskey Shanks
Deputy Secretary of the Board

cc: Nadine Wallman, Vice President
Federal Reserve Bank of Cleveland