

**Meeting between Federal Reserve Board Staff and
Representatives of the Institute of International Bankers
November 29, 2012**

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Summary: Staff of the Federal Reserve Board met with representatives of the Institute of International Bankers (“IIB”) to discuss section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), otherwise known as the so-called “swaps push-out” provision.

Among matters discussed were IIB’s views regarding: the treatment of U.S. uninsured branches and agencies of foreign banking organizations; potential implications for section 716 of registering the head office of a foreign bank as a swap dealer; potential impact of the CFTC’s interpretative guidance regarding cross-border application of certain swaps related provisions of the Commodity Exchange Act; and efforts toward amendments to section 716.



November 29, 2011

**Avoiding Discriminatory Effects of
Section 716 of Dodd-Frank—“Swaps Push-out”—on the
U.S. Operations of Foreign Banks**

For the U.S. operations of foreign banks, a critical issue that emerged from the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)¹ was the potentially discriminatory effects of Section 716, commonly known as “swaps push-out.” Depending on how Section 716 is interpreted and applied by the Federal Reserve, it could lead to explicit discrimination against foreign banks’ U.S. banking operations, which would violate the long-standing U.S. policy of national treatment for foreign banks operating in the United States and contravene Congress’s clearly articulated intent. This paper discusses the interpretive and implementation issues that the Federal Reserve will need to address in relation to foreign banks under Section 716 and proposes a framework that is designed to avoid discriminatory effects on foreign banks’ U.S. operations.

Section 716 generally provides that no “Federal assistance” (including advances from the Federal Reserve’s discount window) may be provided to any registered swap dealer, security-based swap dealer, major swap participant or major security-based swap participant (each, a “swaps entity”) with respect to any swap, security-based swap or other activity of the swaps entity.² This general prohibition is subject to several important exclusions, grandfathering provisions and transition periods for “insured depository institutions” (“IDIs”).

The statutory language in Section 716 is far from clear. Unlike other statutes, Section 716 does not define the term “insured depository institution,” and key legislators acknowledged that there was a need “to ensure that uninsured U.S. branches and agencies of foreign banks are treated the same as insured depository institutions.”³ In addition, the prohibition on providing Federal assistance in Section 716(a) refers to Federal assistance provided “with respect to any swap, security-based swap, or other activity” of a swaps entity, which reference needs to be given meaning since Congress could have—but did not—simply state that no Federal assistance could be provided to any swaps entity. Finally, the definition of “Federal assistance” contains language

¹ Public Law 111-203 (July 21, 2010).

² In this paper, references to “swaps” include “security-based swaps” unless otherwise specified or required by context.

³ 156 Cong. Rec. S5903-S5904 (daily ed. July 15, 2010) (colloquy between Senator Dodd, Chairman of the Senate Banking Committee, and Senator Lincoln, Chairman of the Senate Agriculture Committee and sponsor of Section 716).



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limiting it to cover only assistance provided for certain purposes but which, when placed into the relevant part of the sentence containing Section 716(a)'s prohibition, results in grammatical errors that require interpretation to give the prohibition meaning.

The lack of clarity in the wording of Section 716 has created significant uncertainty for foreign banks operating in the United States. Left unaddressed, it will force foreign banks not only to cease swap dealing out of their uninsured U.S. branches and agencies, but also in some cases they—and their counterparties—will have to undertake the very significant burden of negotiating to assign or novate entire existing portfolios. This is because, as noted above, Section 716's grandfathering and transition provisions apply only to IDIs.

Counterparties and foreign banks will need many months, if not more, to negotiate the assignment or novation of swap portfolios held with foreign banks' uninsured U.S. branches and agencies—and since counterparties are not required contractually to agree to assign or novate their portfolios, parties may be forced to litigate whether Section 716 triggers “illegality” and similar provisions in swap agreements that are not assigned or novated.

In addition, foreign banks are currently evaluating which entities will need to register as swaps entities under Dodd-Frank. They cannot reasonably be expected to register their uninsured U.S. branches and agencies if uncertainty regarding the reach of Section 716 continues.

At the same time, foreign banks cannot begin to restructure their uninsured U.S. branches' and agencies' swap activities to comply with Section 716 until the cross-border application of Dodd-Frank's swap entity regulatory regime is clarified, since any affiliate to which a U.S. counterparty's swap portfolio is novated will very likely need to be an entity that will register as a swap entity.

As a result, absent guidance on Section 716, foreign banks will effectively be forced to restructure their uninsured U.S. branches' and agencies' swap activities during the brief window between when the CFTC and SEC final rules requiring registration are published and when those rules become effective, which potentially could be as soon as the first half of 2012.

Thus, foreign banks need to evaluate now whether their uninsured U.S. branches and agencies could eventually lose the ability to borrow from the Federal Reserve's discount window or become subject to significant limitations on their swap positions and activities, limitations that Section 716 does not place on U.S. FDIC-insured banks. Such a result would be extremely harmful and disruptive to foreign banks and their U.S. and non-U.S. customers. It also would contradict the long-standing U.S. policy of national treatment.



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It is clear, however, that Section 716 was not intended to have these consequences. Moreover, there is an interpretive framework that allows the Federal Reserve to implement Section 716 in a way that avoids them. This paper describes that framework. We strongly urge the Federal Reserve, the U.S. Treasury and other U.S. policymakers to support an approach that resolves Section 716's ambiguities in a way that avoids market disruption, avoids discrimination against foreign banks, and focuses on Section 716's clear objective: to prevent the use of U.S. government assistance to "bail out" or otherwise support activities involving swaps or security-based swaps.

Background

Many foreign banks operate uninsured branches and agencies in the United States.⁴ In addition to lending and engaging in certain securities, asset management and other similar activities, many such branches and agencies also enter into swaps. Because Dodd-Frank's "swap dealer" definition is very broad—including any person who "regularly enters into swaps with counterparties as an ordinary course of business for its own account"⁵—nearly any uninsured U.S. branch or agency that enters into swaps with customers, even on an occasional basis, may be regarded as a swap dealer. These branches and agencies include a wide range of institutions, from some of the largest, systemically significant global swap dealers, to foreign banks with much smaller U.S. operations that, like U.S. community banks, enter into swaps solely in connection with their lending activities.⁶ Dodd-Frank provides that those uninsured U.S. branches and agencies will be required to register with the Commodity Futures Trading Commission ("CFTC") and/or Securities and Exchange Commission ("SEC") with respect to their swap dealing activity (although, as discussed below, they will not be considered to be swap dealers for their other, non-swap activities).

In addition, the uninsured U.S. branches and agencies of foreign banks are all licensed by a federal or state banking authority, they are subject to the same type of safety and soundness examination and oversight as U.S. banks, and, like U.S. banks, they are eligible to borrow from the Federal Reserve discount window under applicable law and Federal Reserve regulations so long as the advance is secured by high quality

⁴ A small number (8) of foreign banks instead operate insured branches on a grandfathered basis. Such insured branches would clearly be "insured depository institutions" for purposes of Section 716.

⁵ Section 1a(49)(A)(iii) of the Commodity Exchange Act ("CEA").

⁶ Although Section 1a(49)(A) of the CEA excludes from the swap dealer definition an IDI that offers to enter into a swap with a customer in connection with originating a loan with that customer, that exclusion (like Section 716's exclusions) arguably does not apply to uninsured branches and agencies of foreign banks.



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collateral.⁷ The ability to access the discount window is important for many foreign banks as an accepted part of their funding contingency plans or prudent risk management generally. Similarly, from the Federal Reserve's perspective, the ability to lend to similarly situated banking institutions—U.S. banks and uninsured U.S. branches and agencies of foreign banks—is important to the effectiveness of the Federal Reserve's depository institution lending programs, including the discount window.

Given these considerations, the uninsured U.S. branches and agencies of many foreign banks may become subject to Section 716.

Most of the focus and controversy surrounding Section 716's application to foreign banks' uninsured U.S. branches and agencies has centered on the fact that Section 716's exclusions, grandfathering provisions and transition periods apply to "insured depository institutions." The use of the term "insured depository institution" has created significant doubt about whether uninsured branches and agencies of foreign banks will be equally eligible as U.S. FDIC-insured banks for the benefits of these provisions.

The exclusions, grandfathering provisions and transition periods in Section 716 were the result of last-minute negotiations at the end of the House-Senate conference process for Dodd-Frank. As a result, it was not until after the House had already passed Dodd-Frank that legislators recognized that the references in the provisions to IDIs could be read to exclude the uninsured U.S. branches and agencies of foreign banks. Although the legislators principally responsible for Section 716 expressly recognized that this ambiguity was an "oversight,"⁸ it was too late for the ambiguous language to be amended. The provisions therefore were enacted with the undefined references to IDIs intact, even though congressional intent was clear.

Three critical issues arise from this ambiguity in Section 716:

First, Section 716(d) contains an exclusion that will permit IDIs to continue on an ongoing basis to engage in certain swap dealing activities, including dealing in interest rate, foreign currency, precious metal and certain

⁷ See Federal Reserve Regulation A, 12 C.F.R. § 201.1 (extending rules relating to eligibility for Federal Reserve Bank lending to "United States branches and agencies of foreign banks"); see also Federal Reserve Bank of New York, Fedpoint: The Discount Window ("Federal Reserve Banks lend funds to depository institutions through discount window programs. All depository institutions that maintain transaction accounts or non-personal time deposits subject to reserve requirements are eligible for discount window programs. These include commercial banks, thrift institutions, and U.S. branches and agencies of foreign banks."), available at <http://www.newyorkfed.org/aboutthefed/fedpoint/fed18.html>.

⁸ See Note 3, *supra*.



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credit-related swaps, and to use swaps for hedging and other similar risk-mitigating activities. If uninsured branches and agencies were ineligible for this exclusion, then their U.S. customers would lose the benefit of trading with, and have to establish new trading relationships away from them for the entire range of swaps, not just those outside of Section 716(d)'s exclusions. This would significantly reduce competition and worsen pricing in the U.S. swaps market, especially given that 8 of the 14 largest global derivatives dealers are foreign banks. In addition, the resulting differential treatment relative to U.S. FDIC-insured banks would overtly discriminate against and competitively disadvantage foreign banks, representing a significant departure from the long-standing U.S. policy of national treatment. Finally, it would provide precedent for foreign jurisdictions to provide advantages to their local banks at the expense of the foreign operations of U.S. banks, if not in the context of swaps then potentially in other contexts.

Second, Section 716(b)(2)(B) excludes from the scope of Section 716 an IDI that is a major swap participant or major security-based swap participant. This exclusion is important because the major swap participant and major security-based swap participant definitions encompass not only persons engaged in ongoing swap activities but also potentially persons with legacy positions. Thus, if uninsured branches and agencies were not treated as IDIs for this purpose, then they could be subject to Section 716 as a result of legacy positions in a way that a U.S. FDIC-insured bank would not.

Third, Section 716(e) provides that Section 716's prohibition on Federal assistance "shall only apply to swaps or security-based swaps entered into by an insured depository institution after the end of [Section 716's] transition period." Therefore, the existing swaps of IDIs are grandfathered from Section 716. Relatedly, Section 716(f) gives an IDI's appropriate Federal banking agency the authority to grant the institution a transition period of up to three additional years beyond Section 716's July 16, 2013 effective date before the institution must divest or cease its swap activities. The purpose of this transition period is to prevent the restructurings necessary to comply with Section 716 from adversely disrupting the institution's lending and other non-swaps activities.

The implications of these issues are potentially serious because requiring uninsured U.S. branches and agencies (unlike their U.S. FDIC-insured competitors) to "push out" all their existing swap positions and ongoing swaps activities would be extremely disruptive for both the institutions and their customers, including commercial end users, and time- and cost-intensive:

- The uninsured U.S. branches and agencies of foreign banks make 18% of all bank commercial and industrial loans in the United States. Swap dealing (as broadly defined under Dodd-Frank) is typically conducted as



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an integrated part of banks' lending and other non-swap businesses. Swap positions often hedge loan and other non-swap positions, and risk management and other systems are often shared across many different types of trading activities, not just those involving swaps. Winding down or restructuring swap activities will as a result tend to decrease lending and market making activity, with material impacts on the overall U.S. economy.

- A significant number of customers have master agreements directly with the uninsured U.S. branches and agencies of foreign banks, or have multi-branch netting agreements to which one or more uninsured U.S. branches or agencies are parties. The assignment or novation of these agreements, even to an affiliate, almost always requires counterparty consent, forcing customers and foreign banks to negotiate the terms for assigning, novating or modifying agreements for swap portfolios held with uninsured U.S. branches and agencies.
- Foreign banks and their customers may not always agree to the terms of an assignment or novation thereby forcing the parties to litigate over whether Section 716 triggers "illegality" and similar provisions in swap agreements.
- Renegotiation and litigation will lead to significant delays in trading, resulting in diminished liquidity and higher spreads for customers.
- Assignment or novation of existing positions could potentially trigger other requirements under Dodd-Frank, such as mandatory clearing and trading requirements inasmuch as any such novated or assigned swap potentially would constitute a new swap that would be subject to those requirements.
- There are significant capital and technology costs associated with using a new booking structure, and the modification of existing systems to track new booking structures will put a very heavy strain on information technology resources that are already overwhelmed with the other changes necessary because of Dodd-Frank.

Due to the highly costly and time-consuming nature of these changes, and the absence of any grandfathering or transition period, foreign banks cannot wait until Section 716's July 2013 effective date to begin making these changes. In particular, counterparties and foreign banks will need many months, if not more, to negotiate the assignment or novation of swap portfolios held with foreign banks' uninsured U.S. branches and agencies. In addition, foreign banks are currently evaluating which entities will need to register as swaps entities under Dodd-Frank. They cannot reasonably be



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expected to register their uninsured U.S. branches and agencies if uncertainty regarding the reach of Section 716 continues. At the same time, foreign banks cannot begin to restructure their uninsured U.S. branches' and agencies' swap activities to comply with Section 716 until the cross-border application of Dodd-Frank's swap entity regulatory regime is clarified, since any affiliate to which a U.S. counterparty's swap portfolio is novated or assigned will very likely need to be an entity that will register as a swap entity.

Consequently, absent clarification on Section 716 from the Federal Reserve, foreign banks will effectively be forced to restructure their uninsured U.S. branches' and agencies' swap activities during the brief window between when the CFTC and SEC final rules requiring swap dealer registration are published and when those rules become effective. The Commissions have indicated that they plan to finalize some of those rules before the end of 2011, and registration may be required within the first half of 2012. This short window of time would mean that the transition for foreign banks and their counterparties would be much more disruptive than for U.S. banks, more similar to an insolvency in many respects than to an orderly business restructuring.

Finally, although it is true that the most direct way to address these issues would be for Congress to amend Section 716 to clarify its intent, the prospects for any such legislation being signed into law remain unclear.⁹ Given that uncertainty, the significant time necessary to implement Section 716 and the already-compressed deadline faced by foreign banks, as noted above, most foreign banks have concluded that they cannot rely on an assumption that both the House and the Senate will act in a timely fashion.

Therefore, it is critical that the Federal Reserve, in the near term, provide guidance regarding how it will interpret Section 716 to avoid the unintended consequences described above. As discussed below, the Federal Reserve has ample discretion to avoid these potentially discriminatory and other adverse effects simply by giving the plain words of Section 716 their intended meaning, which is to limit the use of Federal Reserve advances to fund the swaps activities of registered swap dealers and major swap participants.

⁹ On November 15, 2011, the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services agreed to H.R. 1838, the Swaps Bailout Prevention Act, which would amend Section 716 to, among other things, cure the unintended and potential discrimination against foreign banks' uninsured U.S. branches and agencies. Further deliberations in the House on H.R. 1838 have yet to be scheduled.



Legal Analysis

Like many provisions of Dodd-Frank, the amendment that became Section 716 was designed to address concerns following the 2008 financial crisis regarding the intervention of the U.S. government to support the U.S. financial system. As Section 716's title—"Prohibition Against Federal Government Bailouts of Swaps Entities"—makes clear, its focus is on preventing the U.S. government from using public funds to bail out or otherwise support risky swaps activities. Thus, while there are several ways that the Federal Reserve could assure that Section 716 does not result in unintended discriminatory effects and market disruptions, one that is clearly consistent with the plain words of Section 716 and this congressional intent is to implement Section 716 in a manner that prohibits uninsured branches and agencies from using discount window advances to fund activities involving swaps or security-based swaps.¹⁰

Section 716 generally is not, nor was it ever intended to be, a direct limitation on the range of swap activities permissible for a bank. Congress could have, as it did with proprietary trading and private equity and hedge fund activities in Section 619 of Dodd-Frank (known as the "Volcker Rule"), simply prohibited banks from engaging in swap dealing, subject to appropriate exceptions. Instead, throughout all of its permutations during the legislative process, Section 716 took the form of restrictions on the U.S. government's use of public funds to support certain swap-related activities. The focus of Section 716 on limiting the U.S. government's provision of financial assistance to fund swaps activities, rather than limiting banks' activities directly, is apparent from the provisions of Section 716(m), which cross-reference the Volcker Rule as the source of the prohibition on proprietary trading in derivatives by IDIs.

Relevant Text of Section 716

The key operative provision of Section 716 is the prohibition on Federal assistance in subsection (a), which provides:

"Notwithstanding any other provision of law (including regulations), no Federal assistance may be provided to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity."

¹⁰ Alternatively, the Federal Reserve could interpret the term IDI to include the uninsured U.S. branches and agencies of foreign banks for purposes of Section 716, *i.e.*, in addition to the insured U.S. branches of foreign banks. This would be consistent with congressional intent, *see* Note 3 *supra*, and treating uninsured branches and agencies as IDIs for a specific purpose would not be unprecedented. *See* Federal Deposit Insurance Act § 3(c)(3) (12 U.S.C. § 1813(c) (3)) ("The term 'insured depository institution' includes any uninsured branch or agency of a foreign bank ... for purposes of section 1818 of this Title [section 8 of the Federal Deposit Insurance Act].").



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Section 716(b)(1) then defines “Federal assistance” as follows:

“The term ‘Federal assistance’ means 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 for the purpose of—

(A) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;

(B) purchasing the assets of any swaps entity;

(C) guaranteeing any loan or debt issuance of any swaps entity; or

(D) entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.”

Section 716(b)(2) goes on to define “swaps entity” as follows:

“(A) IN GENERAL.—The term ‘swaps entity’ means any swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, that is registered under—

(i) the Commodity Exchange Act (7 U.S.C. 1 et seq.); or

(ii) the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.).

(B) EXCLUSION.—The term ‘swaps entity’ does not include any major swap participant or major security-based swap participant that is an insured depository institution.”

The plain meaning of subsections (a) and (b), as well as associated legislative history, clearly establish that there must be a direct link between the use of the Federal assistance and activities involving swaps or security-based swaps. In other words, the mere fact that a discount window borrower is registered as a swaps entity is not enough for the prohibition on receiving Federal assistance to apply.



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Scope of Prohibition

Subsection (a) limits the scope of Section 716's prohibition to Federal assistance provided "with respect to any swap, security-based swap, or other activity of the swaps entity." The reference in this provision to assistance provided with respect to swaps and security-based swaps is clear. The reference to assistance provided with respect to "other activity of the swaps entity" requires interpretation to give it meaning in context, although we believe the intent and meaning of the plain words in context are equally clear.

Subsection (a) could be read to mean that Federal assistance may not be provided with respect to any activity conducted by a bank that happens to be registered as a swaps entity. Had Congress intended that result, however, it would have provided that "no Federal assistance may be provided to any swaps entity." However, since Congress included the extra phrase "with respect to any swap, security-based swap, or other activity of the swaps entity," canons of statutory construction demand that that phrase have some meaning "so as to avoid rendering superfluous" any statutory language.¹¹

The meaning of the phrase becomes clear when the term "swaps entity" is analyzed in the broader context of Title VII of Dodd-Frank. The definition for "swaps entity" refers back to the definitions for "swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant." Those definitions, in turn, contain limited designation provisions which clearly limit the scope of swap dealer and major swap participant status to a subset of the activities in which a registrant might engage. Specifically, Congress expressly provided in Dodd-Frank's swap dealer definitions that "[a] person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities."¹² Similarly, the major swap participant definitions specify that "a person may be designated as a major

¹¹ Astoria Federal Savings & Loan Ass'n v. Solimino, 501 U.S. 104, 112 (1991); Sprietsma v. Mercury Marine, 537 U.S. 51, 63 (2003) (interpreting word "law" broadly could render the word "regulation" superfluous in preemption clause applicable to a state "law or regulation"); see also Bailey v. United States, 516 U.S. 137, 146 (1995) ("we assume that Congress used two terms because it intended each term to have a particular, nonsuperfluous meaning") (rejecting interpretation that would have made "uses" and "carries" redundant in statute penalizing using or carrying a firearm in commission of offense).

¹² Section 1a(49) of the CEA; see also Section 3(a)(71) of the Securities Exchange Act of 1934 ("Exchange Act") (definition of "security-based swap dealer").



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swap participant for 1 or more categories of swaps without being classified as a major swap participant for all classes of swaps.”¹³

In interpreting these limited designation provisions, the CFTC and SEC have proposed that “a person that satisfies the definition of swap dealer or security-based swap dealer would be a dealer for all types, classes or categories of swaps or security-based swaps, *or activities involving swaps or security-based swaps*, in which the person engages”¹⁴ and that “a person that meets the definition of major participant will be considered to be a major participant with respect to all categories of swaps or security-based swaps, as applicable, and with regard to *all activities involving those instruments*.”¹⁵

Implicit in this interpretation is that a person, including a foreign bank’s uninsured U.S. branch or agency, that satisfies the swap dealer or major swap participant definitions only has that status for activities involving swaps or security-based swaps, but not for other, non-swap/security-based swap activities. And since such a person is, definitionally, not a swap dealer or major swap participant for those non-swap/security-based swap activities under Dodd-Frank generally, there is no reason to believe Section 716 should be any different.

Therefore, the Section 716(a) prohibition should be read as prohibiting Federal assistance from being provided with respect to any swap, security-based swap, or *other activity by a swaps entity involving swaps or security-based swaps—i.e.*, because an institution is a swaps entity only to that extent, and so those are the only activities that could be considered “other activities *of the swaps entity*.”¹⁶

This reading of Section 716(a) is further supported by the legislative history. The conference report accompanying Dodd-Frank describes Section 716 as a prohibition of Federal assistance “to swaps entities *in connection with their trading in*

¹³ Section 1a(33) of the CEA; see also Section 3(a)(67) of the Exchange Act (definition of “major security-based swap participant”).

¹⁴ CFTC and SEC Proposed Rule, Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 Fed. Reg. 80174, 80182 (Dec. 21, 2010) (emphasis added).

¹⁵ Id. at 80200 (emphasis added).

¹⁶ Of course, if a foreign bank is designated as a swap or security-based swap dealer solely with respect to the activities of its head office or another non-U.S. office, then its U.S. branch or agency would also not be a “swaps entity” subject to Section 716.



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*swaps or securities-based swaps.*¹⁷ Furthermore, the phrase “with respect to any swap, security-based swap, or other activity of the swaps entity” was added when the Senate modified the provision that would become Section 716 by amending the definition of “Federal assistance” expressly to mention the Federal Reserve discount window and by expanding the scope of covered swaps entities to include entities, such as swap dealers, that might be banks.¹⁸ These changes meant that banks’ use of discount window advances would become subject to the prohibition for the first time. Thus, a reasonable interpretation of the limiting phrase “with respect to any swap, security-based swap, or other activity of the swaps entity” is that Congress intended for it to preserve the use of discount window advances by banks for traditional, non-swap-related purposes. This interpretation is consistent with Congress’s efforts elsewhere in Section 716 to prevent swaps push-out from unduly disrupting banks’ lending, securities and other non-swap activities.¹⁹

Scope of “Federal assistance”

In addition, in relevant part the definition of “Federal assistance” is limited to “the use” of discount window borrowings “for the purpose of” the transactions enumerated in subparagraphs (A)-(D). Clearly, Congress was focused on the government’s use of federal assistance, not a bank’s mere eligibility. So, if a bank were to suffer losses due to its swap dealing activity in a future financial crisis, then Section 716 would prohibit the Federal Reserve from using advances from the discount window to assist the bank with covering those losses. But Section 716 should not prohibit the Federal Reserve from using advances from the discount window for purposes not related to swaps.

Policy Implications

Adopting the interpretation that Section 716 limits only the use of discount window advances and other forms of Federal assistance to support activities involving swaps or security-based swaps would address some of the key policy concerns that have been raised with respect to Section 716.

¹⁷ H.R. Rep. No. 111-517, at 869 (2010) (emphasis added).

¹⁸ Compare Section 3004 of H.R. 4173, as engrossed by the House of Representatives, with Section 716 of H.R. 4173, as engrossed by the Senate.

¹⁹ For instance, Section 716’s IDI transition period provision directs the Federal banking agencies to take into account the potential impact of divesting or ceasing swaps activity on mortgage lending, small business lending, job creation and capital formation. Section 716(f).



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This interpretation would prevent the uninsured U.S. branches and agencies of foreign banks from being required to assign or novate their entire existing swap portfolios, so long as they could, if and when they access the discount window, assure the relevant Federal Reserve Bank that discount window funds will not be used to make payments on swaps in those portfolios. It also would give the Federal Reserve the flexibility to provide some degree of parity between U.S. FDIC-insured banks and foreign bank's uninsured U.S. branches and agencies that Congress intended under Section 716. Instead of interpreting Section 716 flatly to prohibit all swap dealing by uninsured branches and agencies, the Federal Reserve could fashion such conditions on discount window access that it determined necessary to achieve parity.²⁰

Proposed Implementation

Implementation of Section 716 vis-à-vis discount window borrowing is ultimately a question for the Federal Reserve, as it is the Federal Reserve that is prohibited from using discount window advances to fund swaps activities of borrowers. In light of the interpretive framework we have advocated in this paper, we believe it should be relatively straightforward for the Federal Reserve to implement the prohibition in a way that adheres to its plain meaning and intent.

Specifically, we would recommend that the Federal Reserve implement the above interpretation by requiring that, before an uninsured U.S. branch or agency of a foreign bank that is a swaps entity can borrow from the discount window, it must establish that it will not use funds borrowed from the window to support any of its activities involving swaps or security-based swaps. This policy could be implemented, for instance, by amending Operating Circular No. 10 to include specific prohibitions on the use of discount window advances to fund such activities. Alternatively, the Federal Reserve could require the borrowing branch or agency to provide a "purpose statement" similar to, for example, Form U-1, under which the borrower would represent that it is not using the discount window advances to fund any of its activities involving swaps or security-based swaps and would describe the purposes for which it is using those advances.

²⁰ Interpreting the scope of Section 716 based on the use of Federal assistance could also address the concerns that have been raised by U.S. banks with respect to the potential application of Section 716 to their non-U.S. activities. Because the non-U.S. branches of U.S. banks do not typically offer federally insured deposits, and therefore do not "use" FDIC insurance in the same way as their U.S. branches, the non-U.S. branches of U.S. banks should not be subject to Section 716 so long as they do not offer federally insured deposits.