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International Bank for Reconstruction and Development,
International Finance Corporation, and Other Multilateral
Development Institutions in which the United States is a Member –
Comment on the Proposed Rule Entitled "Margin and Capital
Requirements for Covered Swap Entities"[1]

Dear Sirs:

This comment letter is submitted by the International Bank for Reconstruction ("IBRD") and the International Finance Corporation ("IFC"), on behalf of IBRD, IFC, and other multilateral development banks in which the U.S. is a member (the "MDBs")[2] in respect of implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). For the reasons set forth below, we request that the Agencies[3] ensure that the above-referenced proposal is implemented in a manner that does not impair the ability of MDBs to continue to engage in non-cleared swaps with swap dealers and major swap participants on a mutually agreed, bilaterally negotiated basis, rather than being subject to regulatory margin requirements. Furthermore, we request regulatory clarifications to ensure that capital requirements applicable to non-cleared, non-margined swaps with MDBs accurately reflect the minimal risk involved in such exposures.

[1] 76 Fed. Reg. 27,564 (May 11, 2011).

[2] Multilateral development banks in which the Unites States is a member include IBRD, IFC, International Development Association, Multilateral Investment Guarantee Agency, African Development Bank, African Development Fund, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, and Inter-American Investment Corporation. Not all of these institutions currently use derivatives in their development operations, or do so only on a limited basis. Nevertheless, the principles set forth in this letter should apply to all MDBs.

[3] The relevant Agencies and their respective RINs for the proposed rule include the Office of the Comptroller of the Currency (Docket ID OCC-2011-0008 and RIN 1557-AD43), Board of Governors of the Federal Reserve System (Docket No. R-1415 and RIN 7100 AD74), Federal Deposit Insurance Corporation (RIN 3064 AD79), Farm Credit Administration (RIN 3052-AC69), and Federal Housing Finance Agency (RIN 2590-AA45).

1. *Prior Comments by IBRD and IFC and Related Commodity Futures Trading Commission Determinations*

Prior to filing this comment letter, IBRD and IFC have engaged in extensive discussions with the Commodity Futures Trading Commission (the "Commission") on various proposed rules implementing Title VII of the Dodd-Frank Act.[4] For example, IBRD and IFC filed a comment on the proposed rule entitled "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping" on July 22, 2011.[5] In that comment, IBRD and IFC urged the Commission to implement the Dodd-Frank Act in a manner that (1) fully respects the privileges and immunities of IBRD, IFC, and other MDBs, and (2) does not impair the development effectiveness of these institutions, noting that any other result would be contrary to decades of well-settled law. Our comment described the privileges and immunities accorded to IBRD, IFC, and other MDBs, and explained that application of Title VII of the Dodd-Frank Act to these institutions would be inconsistent with the international legal obligations of the United States and would conflict with U.S. statutory law.[6] Our comment further noted that there was no evidence that Congress intended such a result. While the comment was filed in response to the proposed "product definition" rules, IBRD and IFC noted that the MDB community would welcome any regulatory action (or actions) that met the two-pronged test set forth above.

The Commission (in conjunction with the Securities and Exchange Commission) subsequently adopted a rule entitled "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participant'". In discussing the status of certain foreign entities, the Commission cited the above-referenced comment letter filed by IBRD and IFC. In this rulemaking process, the Commission expressly determined that:

> Canons of statutory construction "assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws." There is nothing in the text or history of the swap-related provisions of Title VII to establish that Congress intended to deviate from the traditions of the international system by including foreign governments, foreign central banks and international financial institutions within the definitions of the term "swap dealer" or "major swap participant," thereby requiring that they affirmatively register as swap dealers or major swap participants with the CFTC and be regulated as such. The CFTC does not believe that foreign governments, foreign central banks and international financial institutions should be required to register as swap dealers or major swap participants.[7]

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[4] IBRD, IFC, and the other MDBs do not make substantial use of "security-based swaps", so our comments and consultations to date have focused on the proposed rules that affect interest rate, currency, and other swaps.

[5] A copy of this comment, which includes additional background material on the MDBs, is attached for reference as Attachment 1.

[6] Annex I hereto describes the relevant privileges and immunities of IBRD, IFC, and other MDBs, as well as the steps taken by the United States to implements these immunities in domestic law.

[7] 77 Fed. Reg. 30,596, at 30,693 (May 23, 2012) (footnotes omitted) (the "Entity Definitions Release"). Footnote 1180 on page 30,692 defined the term "international financial institutions" to include, inter alia, IBRD, IFC, and other MDBs in which the United States is a member. While we generally agree with the Commission's reasoning in this making this determination, there is one potentially misleading passage. The Release included a statement that "foreign entities are not necessarily immune from U.S. jurisdiction for commercial activities undertaken with U.S. counterparties or in U.S. markets," and a related footnote that included citations to certain litigation involving MDBs (77 Fed. Reg. 30,692 and footnote 1182). We filed a letter suggesting a clarification to this discussion. In particular, we noted that the immunity of the MDBs from member state regulation and other actions, as set forth in their respective Articles of Agreement and related U.S. implementing legislation, is not affected by whether MDBs engage in commercial behavior. In other words, the general "commercial exception" to sovereign immunity set forth in the Foreign Sovereign Immunities Act, as cited in footnote 1182 of the Entity Definitions Release, does not apply to or limit the immunities conferred on MDBs – the FSIA applies to sovereigns, and MDB privileges and immunities are specified in independent international agreements and different U.S. statutes. Moreover, the court cases cited in the footnote referred to MDB immunity from suits by private parties rather than the entirely distinct immunities from regulation and other actions by members. These points apply equally to the margin rule currently under consideration – the specific immunities of the MDBs from regulation, requisition, seizure, and so on must be

The Commission subsequently adopted a rule entitled "End-User Exception to the Clearing Requirement for Swaps". In discussing the status of certain foreign entities, the Commission again cited the above-referenced comment letter filed by IBRD and IFC. In this rulemaking process, the Commission followed the reasoning set forth in the above-referenced rulemaking and determined that:

> Canons of statutory construction "assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws." In addition, international financial institutions operate with the benefit of certain privileges and immunities under U.S. law indicating that such entities may be viewed similarly under certain circumstances. There is nothing in the text or history of the swap-related provisions of Title VII of the Dodd-Frank Act to establish that Congress intended to deviate from the traditions of the international system by subjecting foreign governments, foreign central banks, or international financial institutions to the clearing requirement set forth in Section 2(h)(1) of the CEA.
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> Given these considerations of comity and in keeping with the traditions of the international system, the Commission believes that foreign governments, foreign central banks, and international financial institutions should not be subject to Section 2(h)(1) of the CEA.[8]

We welcome the determinations by the Commission that IBRD, IFC, and the other MDBs will not be required to register as swap dealers or major swap participants, nor be subject to swap clearing requirements. In particular, we welcome the explicit Commission recognition of the importance of the privileges and immunities accorded to international financial institutions. These two determinations minimize the potential for direct regulation of MDB activities, which would be flatly inconsistent with the privileges and immunities of our organizations.

However, these determinations by the Commission do not address certain other key issues, such as margin or capital requirements for non-cleared swaps. Accordingly, IBRD and IFC filed a subsequent comment with the Commission on its proposed rule entitled "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants"[9] on September 14, 2012. IBRD and IFC also filed a comment with the Working Group on Margining Requirements on the Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives on September 28, 2012. Our comment today to the Agencies covers the proposed margin and capital requirements applicable to entities subject to prudential regulation by the Agencies.

We recognize that the Agencies will reach their own independent conclusions on these matters. However, we believe that the Commission's earlier determinations are based on well-reasoned conclusions about the special status of MDBs under international and domestic U.S. law, which we have quoted at length. We further believe that these conclusions are equally applicable to margin and capital requirements, and should be reflected in the rules on these subject matters issued by the Commission and the Agencies.

As discussed in more detail below, the swap operations of IBRD, IFC, and other MDBs do not present a risk to U.S. financial institutions or to the financial system as a whole. Therefore, imposing margin requirements on transactions with the MDBs would serve no useful purpose – instead, it would

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considered on their own merits. The regulatory immunity accorded to IBRD, IFC, and other MDBs, for example, expressly extends to "restrictions, regulations, controls, and moratoria *of any nature*", and should not be confused with more limited forms of immunity applicable to other types of entities and activities. See IBRD Article VII, Section 6 (emphasis added); equivalent provision at IFC Article VI, Section 4.

[8] 77 Fed. Reg. 42,560, at 42,562 (July 19, 2012) (footnotes omitted) (the "Clearing Release").

[9] 76 Fed. Reg. 23,732 (April 28, 2011).

divert scarce public resources from development needs and degrade the financial capacity and credit standing of the MDBs. The United States is the largest shareholder in IBRD and IFC, as well as the largest contributor to IBRD's ongoing capital increases, and has a strong interest in ensuring that public funds appropriated by Congress have the maximum development impact.

2. *Margin Requirements on MDB Transactions Would Conflict with the Privileges and Immunities of MDBs*

Regulation of non-cleared swap transactions between MDBs and swap dealers or major swap participants would amount to regulation of MDBs, and would be inconsistent with the privileges and immunities of IBRD, IFC, and the other MDBs. In response to a question raised by Gary Gensler, Chairman of the Commission, at a July 6, 2011 meeting, we commissioned the firm of Sullivan & Cromwell to analyze the potential application of the Dodd-Frank Act to our swaps activities. Edwin Williamson, currently Senior Counsel to Sullivan & Cromwell and former Legal Adviser of the U.S. Department of State, was the primary author of the opinion, which we transmitted to Chairman Gensler on October 5, 2011.[10] The Sullivan & Cromwell opinion confirmed that regulation of IBRD and IFC under Title VII of the Dodd-Frank Act would constitute a breach by the United States of its international obligations under the Articles of Agreement of each institution, as implemented in U.S. law under the Bretton Woods Agreements Act and the International Finance Corporation Act. The opinion further concluded that the Dodd-Frank Act does not authorize any such curtailment of the privileges and immunities of IBRD and IFC.

While we urge that the entire Sullivan & Cromwell opinion – as well as our own prior discussion of privileges and immunities – be reviewed in detail, certain sections of the opinion merit special emphasis in the context of the proposed rule at issue. The opinion noted at page 11 that regulation could be imposed either through "Direct Regulation" of IBRD and IFC, or via what it termed "Direct Regulation Equivalent" measures:

> Even if the Organizations [IBRD and IFC] are not required to register as MSPs, if their swap transactions are covered, then transactions with entities that are MSPs or "swap dealers" would subject the Organizations to several of the Direct Regulation measures. For example, the Organizations would be required to post collateral as security for their swap obligations . . . This is in many ways the substantive equivalent of the Organizations being subjected to Direct Regulation, as the Regulations would have the effect of requiring the Organizations to modify their current practices.

The Sullivan & Cromwell opinion then analyzed such collateral requirements in detail on page 12 and concluded as follows:

> The requirement that the Organizations post collateral would violate the Organizations' immunities from attachment and seizure, whether the requirement is imposed as a Direct Regulation or a Direct Regulation Equivalent measure. The Organizations' attachment immunity protects the Organizations' assets from an attachment before the entry of a final judgment. Posting collateral in order to enter into a transaction, particularly when there is no indication that the collateral will ever be called, is the economic equivalent of an attachment prior to a judgment having been entered. The Organizations' immunity from seizure protects the Organizations from any government's attempt to, among other things, requisition the Organizations' assets, such as by requiring that the Organizations use their assets in a prescribed manner. Likewise, requiring that the Organizations use their assets for a purpose other than for the furtherance of their development purposes is the economic equivalent of a requisition, even if it is for a limited purpose.

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[10] A copy of our transmittal letter and the Sullivan & Cromwell opinion is set forth as Attachment 2.

We believe that this reasoning is compelling, and makes the case that margin requirements on non-cleared swaps should not be applied to transactions involving MDBs.

3. *Margin Requirements on MDB Transactions Would Be Inconsistent with the Statutory Mandate of the Agencies and Would Serve No Policy Purpose*

While the privileges and immunities argument set forth above should be dispositive, we also believe that margin requirements on MDB transactions would be inconsistent with the statutory mandate of the Agencies and would serve no policy purpose. Some of the specific comments and financial analysis in this section focus on IBRD and IFC, but they apply more broadly to the MDBs as a whole.

The Agencies themselves described their statutory mandate and articulated the policy goals of the proposed rules under consideration as follows:

> The capital and margin standards for swap entities imposed under sections 731 and 764 of the Dodd-Frank Act are intended to offset the greater risk to the swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared. Sections 731 and 764 of the Dodd-Frank Act require that the capital and margin requirements imposed on swap entities must, to offset such risk, (i) help ensure the safety and soundness of the swap entity and (ii) be appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a swap entity.[11]

Consistent with that statutory mandate, the Agencies have articulated a "risk-based approach" in the proposed rules.[12] Under such an approach, when it comes to the case of MDBs, the question should be whether transactions between MDBs and Covered Swap Entities (i.e., "swap dealers", "major swap participants," "security-based swap dealers", and "major security-based swap participants") present any substantial risks to such counterparties.

Under long-standing, bilaterally-negotiated practices, MDBs generally do not post margin – neither initial nor variation margin – with our counterparties. Such non-cleared, non-margined transactions do not present any material risks to our counterparties (including Covered Swap Entities) or the financial system as a whole. IBRD and IFC are highly credit-worthy entities. Our institutions carry the highest ratings issued by the major credit rating agencies. Moreover, the market valuation of bonds issued by IBRD and IFC demonstrate broad market consensus that our institutions (and other MDBs) are among the safest credits in the capital markets.

Of course, the most compelling evidence for our position comes from the determinations of several of the Agencies themselves in implementing capital requirements for transactions between MDBs and entities subject to their prudential regulation. For example, the federal banking agencies' rules implementing the Basel II internal ratings-based approach exempt any MDB from the minimum probability of default floor of 0.03% for purposes of calculating risk-weighted assets for general credit risk – i.e., they allow prudentially regulated entities to assess the MDB default probability as *zero*.[13] In addition, the recent U.S. Basel III proposals, which introduce a new "standardized approach" to replace the existing Basel I-based generally applicable capital rules, would reduce the risk weight for exposures to MDBs from 20% to *zero* (0%).[14] Finally, under the Market Risk Capital Rule recently adopted by the federal banking agencies,

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[11] 76 Fed. Reg. 27,564, at 27,566 (footnotes omitted).

[12] 76 Fed. Reg. 27564, at 27,567.

[13] See e.g., 12 C.F.R. Part 225 Appendix G, Section 31(d) (2).

[14] As a rationale for assigning a zero percent risk weight to exposures to MDBs, the federal banking agencies stated that this is appropriate "in light of the generally high-credit quality of MDBs, their strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with strong creditworthiness." Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, Regulatory Capital Rules:

U.S. banking organizations that are subject to the rule may assign a *zero* specific risk-weighing factor to a debt position that is (or has) an (underlying) exposure to an MDB.[15] *A decision to impose margin requirements on non-cleared swaps between MDBs and Covered Swap Entities would be inconsistent with the prior determinations of the Agencies themselves in respect of the essentially riskless nature of credit exposures to MDBs.*

Finally, it is worth reiterating that IBRD, IFC, and the other MDBs use swaps solely for risk management purposes. We use these transactions in a straightforward manner, to manage market risk, stabilize income, and help our clients manage market risks. We do not use derivatives for speculation.[16]

As the Agencies themselves noted in proposing the margin rules, their statutory mandate is to adopt capital and margin requirements that are "appropriate" for the risks associated with non-cleared swaps with Covered Swap Entities. There is a clear consensus among credit rating agencies, capital markets participants, and the Agencies themselves that credit exposures to MDBs pose no serious risks. Accordingly, we believe that imposing margin requirements on non-cleared swap transactions between MDBs and Covered Swap Entities would be inconsistent with the statutory mandate of the Agencies and with their own prior determinations, and would serve no policy purpose.[17]

4. *Margin Requirements on MDB Transactions Would Impair the Development Effectiveness of MDBs*

IBRD has undertaken an analysis of potential margin posting requirements under various scenarios, and concluded that it could face a potential posting requirement over the medium term of $20-30 billion under plausible scenarios. Assuming that IBRD would borrow in the financial markets to fund such a collateral requirement, we estimate that our funding cost for collateral would exceed the returns on the very narrow class of assets eligible for posting by approximately 20-30 bps. This suggests a possible cost of carry in the range of $40-90 million per year. This estimate is for IBRD alone; the costs for IFC and other MDBs would be on top of this amount. In addition to cost issues, this liquidity impact should be considered in the context that none of the MDBs has access to a liquidity facility of last resort from the Federal Reserve or other central banks. While some (but not all) MDBs have callable capital, even those MDBs with callable capital backing cannot call it for purposes other than servicing our bond debt and guarantee obligations. This potential loss of tens of millions of dollars per year is a pure deadweight loss that adversely impacts our financial position. Losses of this level will constrain our ability to increase IBRD's financial capacity and to make transfers of IBRD's net income to other development entities, such as the International Development Association ("IDA"), the concessional lending arm of the World Bank Group. This would be in contradiction of the stated policy objectives of the United States as the largest shareholder of IDA.

Some other potential implications are more difficult to quantify, but may be more serious over the long term. IBRD, IFC, and the other MDBs responded to the financial crisis by substantially increasing lending and investment operations, and the elevated level of such operations is expected to continue over

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Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52,888 at 52,896 (Aug. 30, 2012).

[15] Similarly, in the preamble to the Market Risk Capital Rule, the federal banking agencies stated that the zero percent specific risk-weighting factor "is based on these MDBs' generally high-credit quality, strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with strong creditworthiness." Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53,060 at 53,077 (Aug. 30, 2012).

[16] For a more detailed description of how MDBs use swaps, see Annex 2 hereto.

[17] As noted in the Sullivan & Cromwell opinion at page 14 – and confirmed by us herein – the ISDA Master Agreements under which IBRD and IFC conduct swap transactions with commercial counterparties in the U.S. and other jurisdictions provide that IBRD and IFC will not post margin as long as they are rated "AAA" by the major ratings agencies, but will post margin if they are downgraded. Thus, the only effect of imposing regulatory margin requirements on non-cleared swaps between Covered Swap Entities and IBRD and IFC would be to require our institutions to post margin at a time when they present no risk to our counterparties.

the medium term. If we are forced to incur substantial additional borrowings to cover collateral posting requirements above and beyond the level necessary to fund lending and investments, the consequences are uncertain. At a minimum, IBRD, IFC, and the other MDBs will need to hold some capital against the assets that are posted with counterparties, which will either reduce our lending ability or increase our leverage above normal levels. While we will do everything we can to ensure that this situation is managed in a responsible manner, it is possible that the financial markets will take a negative view of a historically unprecedented degree of leverage in our operations.

There are other potential implications as well. IBRD currently provides swap intermediation services for IDA and other development clients. For example, IBRD's swap intermediation services hedge the pledges IDA receives in various currencies into its Special Drawing Right base, so that IDA is protected against foreign exchange risk and can make firm commitments. IDA is not required to post collateral on these transactions, since IBRD is not required to post collateral on its mirror swaps with the market. If IBRD is subject to margin requirements on its transactions with swap dealers and major swap participants, however, this arrangement would be difficult to continue and likely will require IDA and IBRD's other clients to begin posting collateral as well to avoid putting further pressure on IBRD's finances and credit standing. This may significantly increase the cost of doing business for these agencies which provide extremely low cost funding for development, including access to medicine, to the poorest of the poor.

In summary, applying margin requirements to non-cleared swaps with MDBs will increase costs, limit lending and investment operations, divert the use of scarce capital, and potentially affect concessional aid to the poorest of the poor – all for no real policy benefit. Since the United States is the largest shareholder in IBRD, IFC, and other MDBs, and the largest contributor to IBRD's current capital increases, we believe that such an outcome would frustrate U.S. policy interests.

5. Margin Requirements on MDB Transactions Would Create International Comity Concerns

Finally, we note that general international comity considerations independently argue for the results that we are requesting. For example, the Commission articulated the following concern in the Clearing Release:

> The Commission expects that if any of the Federal Government, Federal Reserve Banks, or *international financial institutions of which the United States is a member* were to engage in swap transactions in foreign jurisdictions, the actions of those entities with respect to those transactions would not be subject to foreign regulation. However, if foreign government, central banks, or *international financial institutions* were subjected to regulation by the Commission in connection with their swap transactions, foreign regulators could treat the Federal Government, Federal Reserve Banks, or *international financial institutions of which the United States is a member* in a similar manner.[18]

To be clear, our primary argument for relief from clearing requirements on MDB transactions is that such relief is required as a matter of international and domestic U.S. law, as a consequence of our privileges and immunities. This is entirely independent of comity concerns.[19] However, the Commission's reasoning regarding the international comity interests of the United States applies just as strongly to margin requirements on non-cleared swaps as to clearing requirements for other swaps, and provides yet another independent basis for reaching this result. It is particularly notable that Commission's stated expectation is that "the actions of those [U.S.] entities with respect to those transactions would not be subject to regulation" – i.e., the concern relates to regulation of the relevant *transactions*. An identical concern would arise if a foreign regulator required financial institutions under its jurisdiction to require margin on non-cleared swaps from the aforementioned U.S. entities.

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[18] 77 Fed. Reg. 42,560, at 42561-2 (emphasis added).

[19] Indeed, comity is not generally an issue in the case of MDBs, because all MDB members are similarly obligated as a matter of international law.

In this regard, we note that Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories (also known as "EMIR") has addressed the issue of margin requirements on non-cleared swaps from a European perspective. EMIR exempts EU member central banks and the Bank for International Settlements entirely, and provides a further exemption for multilateral development banks (including the MDBs as defined in this comment letter) and certain other public sector entities, subject to certain reporting requirements. The EMIR also provides a mechanism for reviewing this list of exempted parties and adding central banks and other public bodies outside the EU after a review of the regulatory framework in other major jurisdictions.

IBRD, IFC, and the other MDBs support a common, consistent approach across major jurisdictions in respect of official sector institutions. Consistent with the reasoning of the earlier determinations of the Commission in the U.S. and with the specific margin rules adopted in the EMIR, the Agencies should exclude transactions with MDBs from margin requirements.[20]

6. *Margin Rules - Conclusion*

Taking all of the above factors into account, we believe that the legal and policy considerations that led the Commission to exclude IBRD, IFC, and the other MDBs from swap dealer and major swap participant registration requirements and swap clearing obligations should equally apply in the case of margin requirements, with a similarly comprehensive solution. In particular, just as in those other cases, there is nothing in the text or history of the swap-related provisions of Title VII of the Dodd-Frank Act to establish that Congress intended to deviate from the above-referenced international standards, including the privileges and immunities granted to the MDBs, in the case of margin rules. *Moreover, there is no analytical or evidentiary basis for applying mandatory, mechanistic margin requirements to swap transactions between MDBs and Covered Swap Entities, when the Agencies themselves have already determined that credit exposures to MDBs pose essentially no risk to entities subject to their prudential regulation.*

Accordingly, the final rule or release in the above-referenced matter should include a clear statement that the margin requirements on non-cleared swaps will not apply to transactions between MDBs and Covered Swap Entities, and that Covered Swap Entities will continue to be authorized to negotiate agreements with and enter into transactions with MDBs on a mutually agreed basis.

7. *Regulatory Clarification: Capital Requirements*

IBRD, IFC, and the other MDBs welcome the approach regarding capital requirements taken by the Agencies in the proposed rule, which generally requires a Covered Swap Entity to comply with regulatory capital rules already made applicable to that entity as part of its prudential regulatory regime. However, we will take the opportunity to comment on Question 91, which asks if an alternative capital requirement is appropriate in some cases.

In our view, the relevant Agencies should clarify the application of the proposed capital charge for Credit Valuation Adjustment ("CVA") to transactions with MDBs.[21] Our understanding is that the CVA capital charge is intended to supplement the capital framework for counterparty credit risk by requiring banking organizations to directly reflect CVA risk through an additional capital requirement, which takes

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[20] Regarding the need for consistent standards across jurisdictions, we note that Section 752 of the Dodd-Frank Act specifically provides that "[i]n order to promote effective and consistent global regulation of swaps and security-based swaps, the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the prudential regulators . . . shall consult and coordinate with foreign regulatory authorities on the establishment of *consistent international standards* with respect to the regulation (including fees) of swaps, security-based swaps, swap entities, and security-based swap entities . . ." (emphasis added).

[21] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, "Regulatory Capital Rules: Advance Approaches Risk-Based Capital Rule; Market Risk Capital Rule," 77 Fed. Reg. 52,978 (August 30, 2012).

into account factors such as credit spread volatility. Accordingly, we question the applicability of the CVA capital charge to transactions with MDBs. To start with, as discussed above, the federal banking agencies have already determined that credit exposures to MDBs can generally be assigned a zero risk due to the high credit quality of MDBs. Given the essentially riskless status of credit exposures to MDBs, it is not clear what value a CVA capital charge with respect to such exposures would add. Furthermore, MDBs do not generally exhibit substantial credit volatility, and are not the subject of credit default swaps ("CDS"), so there is no strong empirical basis for developing appropriate CVA charges for transactions with MDBs.

One potential remedy would be to clarify that the CVA capital charge would not apply to transactions with the MDBs, given their special characteristics, or in general to entities that (1) qualify for a zero risk weighting, and (2) are not subject to substantial credit volatility.[22] Another possibility would be to clarify that the VaR models used in the advanced CVA approach can use zero risk weights as proxy spreads (in the absence of CDS) and otherwise be adapted to the highly specialized nature of MDBs. We are open to any solution that provides appropriate clarity to our Covered Swap Entity counterparties.

Accordingly, we request that the relevant Agencies clarify the application of CVA to MDBs in a manner that accurately and appropriately reflects the high credit quality and low credit volatility of MDBs.[23]

8. *Further Regulatory Clarifications: "financial end user"*

We would also like to take the opportunity of this comment to address certain other matters involving implementation of Title VII of the Dodd-Frank Act.

Financial End User - General

As noted above, IBRD, IFC, and the other MDBs seek a categorical exclusion from margin requirements for non-cleared swaps with Covered Swap Entities, similar to the categorical statements provided by the Commission in its Entity Definitions Release and Clearing Release. Nevertheless, given the potential uses of the definitional terms adopted by the Agencies in other contexts (e.g., potential certifications about "financial end user" status in future ISDA agreements or protocols), we believe it is important to resolve the status of MDBs.

Our view is that MDBs should not be considered to be "financial end users". MDBs are official sector entities whose operations focus on development lending and investment. We note that in describing the "financial end user" definition in the context of the proposed rule, the Agencies explained that financial end users pose greater risk to the safety and soundness of Covered Swap Entities. As discussed in detail above, this description simply does not fit MDBs. The Agencies should clarify that MDBs are not considered to be "financial end users" (and certainly not "high risk financial end users" in any event).

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[22] In this respect, we note that the joint comment letter regarding the U.S. Basel III proposals submitted by the American Bankers Association, Securities Industry and Financial Markets Association and The Financial Services Roundtable requests that the proposed CVA capital charge not apply to transactions with MDBs, central banks (such as the Federal Reserve Banks) and similar counterparties that present very low credit risk. *See* Comment Letter from the American Bankers Association, Securities Industry and Financial Markets Association and The Financial Services Roundtable (October 22, 2012), Annex C Section II.C, *available at* http://www.federalreserve.gov/SECRS/2012/October/20121026/R-1442/R-1442_102212_110014_386243203248_1.pdf. The joint comment letter regarding the U.S. Basel III proposals submitted by The Clearinghouse Association and the American Securitization Forum requests a similar exclusion from the CVA capital charge for transactions with MBDs, central banks and other similar counterparties. *See* Comment Letter from The Clearinghouse Association and the American Securitization Forum (October 22, 2012), Section V.E., *available at* http://www.federalreserve.gov/SECRS/2012/October/20121025/R-1442/R-1442_102312_109652_373891000684_1.pdf.

[23] If this issue is more appropriately addressed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation in connection with the proposed rule entitled "Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule," 77 Fed. Reg. 52,978 (August 30, 2012), then we request that our comment on the CVA issue be considered in connection with that rulemaking process.

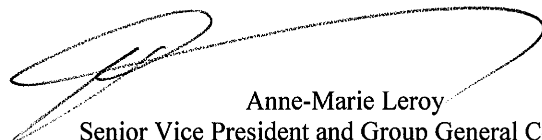
Financial End User – MDB Pension Plans

As a distinct point, we note that the proposed definition of "financial end user" includes "[a]n employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974". The employee benefit plans of the World Bank – which cover IBRD, IFC, IDA, and the Multilateral Insurance Guaranty Agency – technically fall within this description, since they are plans as defined in the relevant paragraphs of ERISA. Of course, the World Bank employee benefit plans – as well as the pension plans maintained by other MDBs – are not subject to regulation under ERISA, given our privileges and immunities. More broadly, IBRD holds legal title to the assets of the employee benefits plans, and these plans are covered by the privileges and immunities of IBRD in all respects. Accordingly, consistent with the reasoning set forth by the Commission in the Entity Definitions Release and the Clearing Release, we seek confirmation from the Agencies that the employee benefit plans of MDBs will not be considered "financial end users" for purposes of the proposed margin rules or any other rules issued in implementation of Title VII of the Dodd-Frank Act.

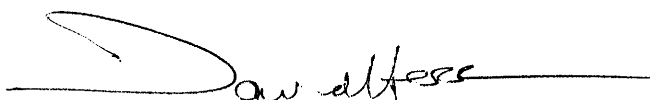
9. Conclusion

We believe that implementation to date of Title VII of the Dodd-Frank Act by the Commission has appropriately recognized the special status of IBRD, IFC, and the other MDBs, and respectfully request the Agencies to reach a similar resolution of the margin rules, capital requirements, and definitional issues discussed above.

Sincerely,



Anne-Marie Leroy
Senior Vice President and Group General Counsel
World Bank



David Harris
Acting Vice President and General Counsel
International Finance Corporation

Attachments

Annex 1: Privileges and Immunities of IBRD, IFC, and other MDBs

The Articles of Agreement of IBRD and IFC include a comprehensive set of privileges and immunities. For the purposes of this discussion, the most salient provisions in the Articles of Agreement of IBRD (referred to as "the Bank" in its Articles) and IFC are as follows:

- "No actions shall . . . be brought [against the Bank] by members or persons acting for or deriving claims from members." (IBRD Article VII, Section 3; equivalent provision at IFC Article VI, Section 3);

- "Property and assets of the Bank, wherever located and by whomsoever held, shall be immune from search, requisition, confiscation, expropriation or any other form of seizure by executive or legislative action" (IBRD Article VII, Section 4; equivalent provision at IFC Article VI, Section 4);

- "The archives of the Bank shall be inviolable" (IBRD Article VII, Section 5; equivalent provision at IFC Article VI, Section 5); and

- "To the extent necessary to carry out the operations provided for in this Agreement and subject to the provisions of this Agreement, all property and assets of the Bank shall be free from restrictions, *regulations*, controls and moratoria *of any nature*" (IBRD Article VII, Section 6 (emphasis added); equivalent provision at IFC Article VI, Section 6).

In addition to embodying these privileges and immunities in the international legal agreements that created IBRD, IFC, and the other MDBs, all member governments agreed to accept and implement these provisions in domestic law. For example, IBRD Article VII, Section 10 provides that "[e]ach member shall take such action as is necessary in its own territories for the purpose of making effective in terms of its own law the principles set forth in this Article and shall inform the Bank of the detailed action which it has taken". IFC Article VI, Section 10 is substantively identical. The United States fulfilled its obligations in respect of IBRD and IFC as follows:

- The Bretton Woods Agreements Act provides that: "the provisions of . . . article VII, sections 2 to 9, both inclusive, of the Articles of Agreement of the Bank, shall have full force and effect in the United States and its Territories and possessions upon acceptance of membership by the United States in, and the establishment of . . . the Bank . . ." (22 U.S.C. §286h)

- The International Finance Corporation Act provides that: "[t]he provisions of . . . article VI, sections 2-9, both inclusive, of the Articles of Agreement of the Corporation shall have full force and effect in the United States and its Territories and possessions upon acceptance of membership by the United States in, and the establishment of . . . the Corporation." (22 U.S.C. §282g)

In addition, the United States has adopted the International Organizations and Immunities Act (22 U.S.C. §288) and the Foreign Sovereign Immunities Act (28 U.S.C. §1602), both of which grant additional protections to IBRD, IFC, and other MDBs.

The organizational documents and charters of the other MDBs contain equivalent privileges and immunities, and the United States has taken appropriate actions to implement its international obligations in domestic law in respect of the other MDBs.[24]

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[24] *See, e.g.*, 22 U.S.C. §283g (Inter-American Development Bank Act), 22 U.S.C. §283hh (Inter-American Investment Corporation Act), 22 U.S.C. §284g (International Development Association Act), 22 U.S.C. §285g (Asian Development Bank Act), 22 U.S.C. §290g-7 (African Development Fund), 22 U.S.C. §290*i*-8 (African Development Bank Act), 22 U.S.C. §290*k* -10 (Multilateral Investment Guarantee Agency Act), and 22 U.S.C. §290*l*-6 (European Bank for Reconstruction and Development Act).

While the above discussion focuses on the steps the United States has taken to implement its international legal obligations in respect of MDBs, we note that the obligations on all other member countries are identical, and that members have provided evidence of the steps they have taken to implement such provisions in their own territories as part of their membership obligations.

The purpose of these privileges and immunities is to avoid subjecting international organizations to multiple, potentially conflicting requirements imposed by national regulators – not to free MDBs from official oversight. To the contrary, IBRD and IFC have resident Boards, with all members appointed or elected by our sovereign shareholders. The resident Boards (and the Audit Committee thereof) have in-depth familiarity with, and oversight authority over, IBRD's and IFC's financial operations. Among other responsibilities, the Boards authorize all categories of derivatives use by IBRD and IFC, and receive regular reports on treasury and risk management operations. While the Boards of MDBs are not acting as regulators, they are all concerned with the financial health and sustainability of their respective institutions, and take risk management issues seriously.

Annex 2: Use of Derivatives by Multilateral Development Banks (MDBs)[25]

MDBs use over-the-counter (OTC) derivatives to manage their exposure to fluctuations in interest and currency rates, to reduce funding costs of their borrowing activities, to control risk and improve return in their reserves portfolios, and to provide risk management solutions for clients. We do not use derivatives for speculation.

MDBs use derivatives in connection with their liabilities to diversify funding sources and offer new debt products to investors. Generally, MDBs swap new funding into the main currency(ies) of denomination and interest rate bases of their emerging market loan assets to minimize currency and interest rate risks in their balance sheets. Conversion to other currencies or into fixed-rate funding is carried out subsequently, also through swaps, in accordance with clients' choices of loan terms. MDBs also use interest rate swaps and currency swaps for asset-liability management purposes to match the pool of liabilities as closely as possible to the interest rate and currency characteristics of liquid assets and loans.

In addition to activity for their own accounts, MDBs facilitate access to hedging tools for their clients and other international development institutions to help meet risk management needs.[26] Provision of instruments such as currency swaps (including into clients' local currencies) and interest rate swaps, caps and collars assists clients in managing interest rate and currency risks, while less common tools such as drought risk contracts have helped with more fundamental environmental and development issues. MDBs fully offset the exposure they create providing these services by hedging them in the derivatives market.

Customized derivatives are an important part of MDBs' development banking operations. These tools allow MDBs to transform the cashflows of their loans to meet changing clients risk management needs. Clients can eliminate foreign exchange risk by hedging cashflows into their local currency, and eliminate debt service fluctuations by fixing the interest rates on their loans.

MDBs have the capacity to effectively manage OTC derivatives operations, including transaction valuation tools and collateral management operations. All MDBs control the credit exposures on swaps through specific credit-rating requirements for counterparties and other credit assessment tools used by independent credit risk units. MDBs also manage risk through netting, collateralization and other arrangements in the legal agreements governing derivatives transactions.

MDBs have robust capital structures and backing from sovereign shareholders. MDBs are among the safest counterparties in the markets, as recognized by the low risk weightings assigned to transactions with MDBs by banking regulators under the Basel II framework and the high ratings assigned by credit rating agencies. While MDBs are an important part of the international financial system, the aggregate volume of derivatives transactions involving MDBs are not so large as to create systemic risk in the market.

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[25] The information contained herein pertains to the following MDBs that are active users of the international capital markets. Besides the IBRD and the IFC, these are: African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, and Inter-American Development Bank.

[26] For example, at present IBRD intermediates currency and interest rate hedging tools for two other international development institutions: the International Finance Facility for Immunisation (IFFIm) and the International Development Association (IDA), another member of the World Bank Group. In both cases, IBRD's derivatives intermediation helps to ensure that the value of multi-year pledges by donor governments in various currencies are insulated from foreign exchange movements, so that IFFIm and IDA can plan multiyear vaccine purchase and development projects, respectively, all for the benefit of the poorest countries.