Swaps Pushout Rule: Federal Reserve Clarifies Treatment of U.S. Branches of Foreign Banks

June 6, 2013

The Federal Reserve has issued an **interim final rule** clarifying the treatment of uninsured U.S. branches and agencies of foreign banks under Section 716 of the Dodd-Frank Act ("**Swaps Pushout Rule**"). The interim final rule clarifies that, for purposes of the Swaps Pushout Rule, all uninsured U.S. branches and agencies of foreign banks are treated as insured depository institutions. Accordingly, a foreign bank swap dealer's uninsured U.S. branch or agency will benefit from the Swaps Pushout Rule's exemptions, transition period and grandfathering provisions to the same extent as an insured depository institution. The interim final rule also establishes a process for uninsured state branches and agencies of foreign banks and state member banks to apply to the Federal Reserve for a transition period from the July 16, 2013 effective date of the Swaps Pushout Rule. The interim final rule became effective on June 5, 2013, and comments on the rule are due on August 4, 2013.

Background on the Swaps Pushout Rule

What Does the Swaps Pushout Rule Do? By its terms, the Swaps Pushout Rule prohibits any "federal assistance" from being provided to "swaps entities," including registered swap dealers, security-based swap dealers, major swap participants and major security-based swap participants.[1] "Federal assistance" includes FDIC deposit insurance and access to the Federal Reserve's discount window. This means, for example, that a bank that registers as a swap dealer[2] will *not* be eligible for deposit insurance or access to the Federal Reserve's discount window *unless* the bank "pushes out" its swap activities to non-bank affiliates that are not eligible for deposit insurance or access to the Federal Reserve's discount window, or ceases to engage in such swaps activities altogether, subject to any applicable exemption, transition period or grandfathering provision.

Exemptions, Transition Period and Grandfathering Provisions. The statutory text of the Swaps Pushout Rule contains an exemption that allows an "insured depository institution" to engage in swaps used to hedge or mitigate risk and swaps involving rates or national bank-eligible assets (*e.g.*, interest rate swaps and swaps that reference currencies, bullion metals, loans or bank-eligible debt securities), other than uncleared credit default swaps. The Swaps Pushout Rule also authorizes the appropriate U.S. banking agency, after consulting with the CFTC and the SEC, to provide an "insured depository institution" a transition period of up to two years, which can be extended by one additional year, to cease any non-exempt swap activities. In addition, there is a grandfathering provision providing that the Swaps Pushout Rule will only apply to swaps entered into by an "insured depository institution" after the end of the transition period.

Federal Reserve's Clarification for Foreign Bank Swap Dealers

Prior to the Federal Reserve's interim final rule, there was significant uncertainty regarding the impact of the Swaps Pushout Rule on foreign banks. For example, it was unclear whether uninsured U.S. branches and agencies of foreign bank swap dealers would benefit from the Swaps Pushout Rule's exemptions, transition

[1] "Insured depository institutions" that register as major swap participants or major security-based swap participants are excluded from the definition of "swaps entity."

[2] Unless otherwise indicated, references to "swap," "swap dealer" and "major swap participant" also refer to security-based swap, security-based swap dealer and major security-based swap participant, respectively.

period and grandfathering provisions, which, on the face of the statute, applied only to "insured depository institutions." A significant number of foreign banks that have registered or will soon register as swaps entities operate branches or agencies in the United States that are not eligible for deposit insurance, but that have access to the Federal Reserve's discount window.[3]

The Federal Reserve's interim final rule clarifies that all uninsured U.S. branches and agencies of foreign banks, *i.e.*, both federally-licensed and state-licensed branches and agencies, are treated as insured depository institutions for purposes of the Swaps Pushout Rule. Accordingly, an uninsured U.S. branch or agency of a foreign bank swap dealer will benefit from the Swaps Pushout Rule's exemptions, transition period and grandfathering provisions to the same extent as an insured depository institution.

The Federal Reserve provided a number of justifications for its interpretive resolution of the ambiguity surrounding the term "insured depository institution" as used in the Swaps Pushout Rule. It noted that for certain purposes of the Federal Deposit Insurance Act, the term "insured depository institution" is defined to include an uninsured U.S. branch or agency of a foreign bank. The Federal Reserve also pointed out that both uninsured and insured U.S. branches and agencies of foreign banks may receive discount window advances on the same terms and conditions that apply to insured state member banks, which means that uninsured U.S. branches and agencies of foreign banks are treated as insured member banks for purposes of the only federal assistance that causes uninsured U.S. branches and agencies of foreign banks to be affected by the Swaps Pushout Rule.

According to the Federal Reserve, treating uninsured U.S. branches and agencies as insured depository institutions furthers the objectives of Title VII of the Dodd-Frank Act by providing sufficient opportunity for uninsured U.S. branches and agencies to conform or cease their swaps activities in an orderly manner and to continue the same risk-mitigating hedging and other activities permitted for insured depository institutions. The Federal Reserve also noted that its interim final rule is consistent with the legislative history of the Swaps Pushout Rule, which suggests that Congress intended to treat uninsured branches and agencies as insured depository institutions.[4]

Where to Book Non-exempt Swaps That Must Be Pushed Out of Uninsured U.S. Branches and Agencies?

The Federal Reserve's interim final rule does not expressly address the question of where an uninsured U.S. branch or agency of a foreign bank swap dealer must book its non-exempt swaps (*e.g.*, uncleared credit default swaps and equity swaps) after the end of the transition period. However, it would appear that by treating an uninsured U.S. branch or agency of a foreign bank swap dealer as an "insured depository institution," which term includes separately incorporated U.S. insured banks, the Federal Reserve is implicitly embracing the separate entity doctrine in the Swaps Pushout Rule context. Applying the separate entity doctrine, U.S. federal and state courts and banking agencies have treated branches of foreign banks as legally

[3] Approximately half of the 80 entities that provisionally registered with the CFTC as swap dealers as of June 6, 2013 are affiliated with foreign banks. As of December 31, 2012, there were approximately 182 uninsured state and federally licensed branches of foreign banks; 44 uninsured state and federally licensed agencies of foreign banks; and 10 grandfathered insured state and federally licensed branches of foreign banks. *See* Federal Reserve, Structure and Share Data for U.S. Banking Offices of Foreign Entities (Dec. 2012), available **here**.

[4] According to former Senator Blanche Lincoln, the principal author of the Swaps Pushout Rule, and former Senate Banking Committee Chairman Christopher Dodd, the Swap Pushout Rule's failure to expressly extend the insured depository institution exemptions and transition period provisions to the uninsured U.S. branches and agencies of foreign banks was an "unfortunate and clearly unintended" legislative "oversight." *See* 156 Cong. Rec. S5903-S5904 (daily ed. Jul. 15, 2010) (Colloquy between Senator Christopher Dodd, Chairman of the Senate Banking Committee, and Senator Blanche Lincoln, Chairman of the Senate Agriculture Committee and sponsor of the Swaps Pushout Rule).

separate entities that are separate from the foreign bank as a whole and separate from each other branch for purposes of many U.S. banking and non-banking laws and regulations.[5]

The statutory text of the Swaps Pushout Rule permits an "insured depository institution" to push its non-exempt swaps to an affiliate that does not receive federal assistance. Since an uninsured U.S. branch or agency of a foreign bank swap dealer is treated as an "insured depository institution," it should be permitted to push its non-exempt swaps to an affiliated "insured depository institution" that does not receive federal assistance, *i.e.*, another uninsured U.S. branch or agency of the *same* foreign bank that does not have access to the Federal Reserve's discount window. Such an approach would be consistent with the fact that discount window access is granted on a branch-by-branch basis and not to the foreign bank as a whole or to its non-U.S. branches.

Since an uninsured U.S. branch or agency of a foreign bank swap dealer is treated as an "insured depository institution" for purposes of the Swaps Pushout Rule, it should be considered a separate entity from the foreign bank swap dealer's non-U.S. branches. Because its non-U.S. offices do not receive federal assistance, a foreign bank should be permitted to push non-exempt swaps from its uninsured U.S. branch or agency to its non-U.S. offices. This approach would be consistent with Federal Reserve Governor Tarullo's remarks in 2012 that the Swaps Pushout Rule "will require U.S. banking firms to restructure their global derivatives dealing activities in ways that will not be required of foreign banks abroad,"[6] which suggests that the Swaps Pushout Rule would not apply to non-U.S. offices of foreign bank swap dealers.

Swaps Pushout Rule Remains Controversial

Notwithstanding the Federal Reserve's interim final rule, the Swaps Pushout Rule remains one of the most controversial provisions of the Dodd-Frank Act. The Swaps Pushout Rule was opposed by the heads of all three federal banking agencies[7] as well as Paul Volcker.[8] Both Federal Reserve Chairman Ben Bernanke and former FDIC Chairman Sheila Bair said it would increase systemic risk, rather than reduce it.[9] The Swaps Pushout Rule has not improved with age. Indeed, one of the key lessons from the preparation of resolution plans under Title I of the Dodd-Frank Act, and recent simulations of the resolution of a systemically important financial institution under Title II of the Dodd-Frank Act,[10] is that pushing swaps out of insured banks into non-bank affiliates creates an impediment to the orderly resolution of banking groups.

When swaps are held within an insured bank, their value can be preserved for the benefit of the bank's creditors (including the FDIC's Deposit Insurance Fund) and the stability of the financial system because the FDIC has the statutory power and incentive to transfer the swaps to a creditworthy third party or bridge bank within one business day after the original bank's failure, overriding any otherwise applicable rights of counterparties to terminate the swaps solely as a result of the failure (and not a separate payment default). In contrast, counterparties have the right to immediately terminate swaps held within a non-bank affiliate under

[5] *See* Cleary Gottlieb Steen & Hamilton LLP, Davis Polk & Wardwell LLP and Sullivan & Cromwell LLP, White Paper on the Separate Entity Doctrine as Applied to the U.S. Branches of Foreign Headquartered (Non-U.S.) Banks (Apr. 19, 2012), available **here**.

[6] Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs, Washington, D.C. (Mar. 22, 2012), available **here**.

[7] *See* Letter from Ben Bernanke, Federal Reserve Chairman, to Senator Christopher Dodd (May 13, 2010), available **here**; Letter from Sheila Bair, FDIC Chairman, to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), available **here**; Remarks by John Dugan, then Comptroller of the Currency, at the Thomson Reuters Global Financial Regulation Summit 2010 (Apr. 27, 2010).

[8] *See* Letter from Paul Volcker, former Federal Reserve Chairman, to Senator Christopher Dodd (May 6, 2010), available **here**.

[9] *See* Letter from Ben Bernanke, Federal Reserve Chairman, to Senator Christopher Dodd (May 13, 2010), available **here**; Letter from Sheila Bair, FDIC Chairman, to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), available **here**.

[10] *See, e.g.*, American Banker, The Inside Story of How the Clearing House Proved Dodd-Frank Works (Dec. 19, 2012), available **here**.

the Bankruptcy Code, and bankruptcy courts have no power to override those rights by transferring the contracts to a creditworthy third party or bridge company. Selective termination of swaps by a bankrupt entity's counterparties typically results in the sort of value destruction and severe market disruption that occurred in the Lehman bankruptcy. As a result, there have been numerous efforts, including bills now pending, since the enactment of the Swaps Pushout Rule in July 2010 to repeal or significantly modify it.

Content of Requests for a Transition Period

The interim final rule provides that a state member bank and an uninsured state branch and agency of foreign bank may seek a transition period of up to two years from July 16, 2013, for an entity that is a swaps entity as of July 16, 2013, or from the date on which the entity becomes a swaps entity, if that date occurs after July 16, 2013, by submitting a written request to the Federal Reserve. The written request must include:

- the length of the transition period requested;
- a description of the quantitative and qualitative impact of immediate divestiture or cessation of swap activities on the institution, including regarding the potential impact of divestiture or cessation of swap activities on the institution's mortgage lending, small business lending, job creation, capital formation versus the potential negative impact on insured depositors and the FDIC's Deposit Insurance Fund; and
- a description of the institution's plan for conforming its activities to the requirements of the Swaps Pushout Rule.

The Federal Reserve may request additional information that it believes is necessary in order to act on a request for a transition period.

The interim final rule provides that the Federal Reserve will seek to act on a request for a transition period expeditiously after the receipt of a complete request. The Federal Reserve may impose conditions on any transition period that it determines to be necessary and appropriate. The interim final rule also permits the Federal Reserve, in consultation with the SEC and CFTC, as appropriate, to extend the transition period for up to one additional year. To request an extension of the transition period, an institution must submit a written request no later than 60 days before the end of the transition period.

Uninsured Federal Branches and Agencies of Foreign Banks: The OCC, not the Federal Reserve, is the primary regulator for uninsured federal branches and agencies of foreign banks. While the Federal Reserve's clarification that *all* uninsured U.S. branches and agencies are treated as "insured depository institutions" for purposes of the Swaps Pushout Rule, the Federal Reserve will not accept transition period requests from uninsured federal branches and agencies of foreign banks.

In January 2013, the OCC issued guidance notifying national banks, federal savings associations and *insured* federal branches of foreign banks that they can submit a formal request for a Swaps Pushout Rule transition period by January 31, 2013.[11] It remains to be seen whether, in view of the Federal Reserve's clarification, the OCC will now accept transition period requests from uninsured federal branches and agencies of foreign banks.

[11] Davis Polk's memorandum on the OCC's January 2013 guidance is available **here**.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Luigi L. De Ghenghi	212 450 4296	luigi.deghenghi@davispolk.com
Susan C. Ervin	202 962 7141	susan.ervin@davispolk.com
Randall D. Guynn	212 450 4239	randall.guynn@davispolk.com
Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Lanny A. Schwartz	212 450 4174	lanny.schwartz@davispolk.com
Margaret E. Tahyar	212 450 4379	margaret.tahyar@davispolk.com
Andrew S. Fei	212 450 4063	andrew.fei@davispolk.com
E. Ashley Harris	212 450 4780	ashley.harris@davispolk.com
Jai R. Massari	202 962 7062	jai.massari@davispolk.com
Gabriel D. Rosenberg	212 450 4537	gabriel.rosenberg@davispolk.com