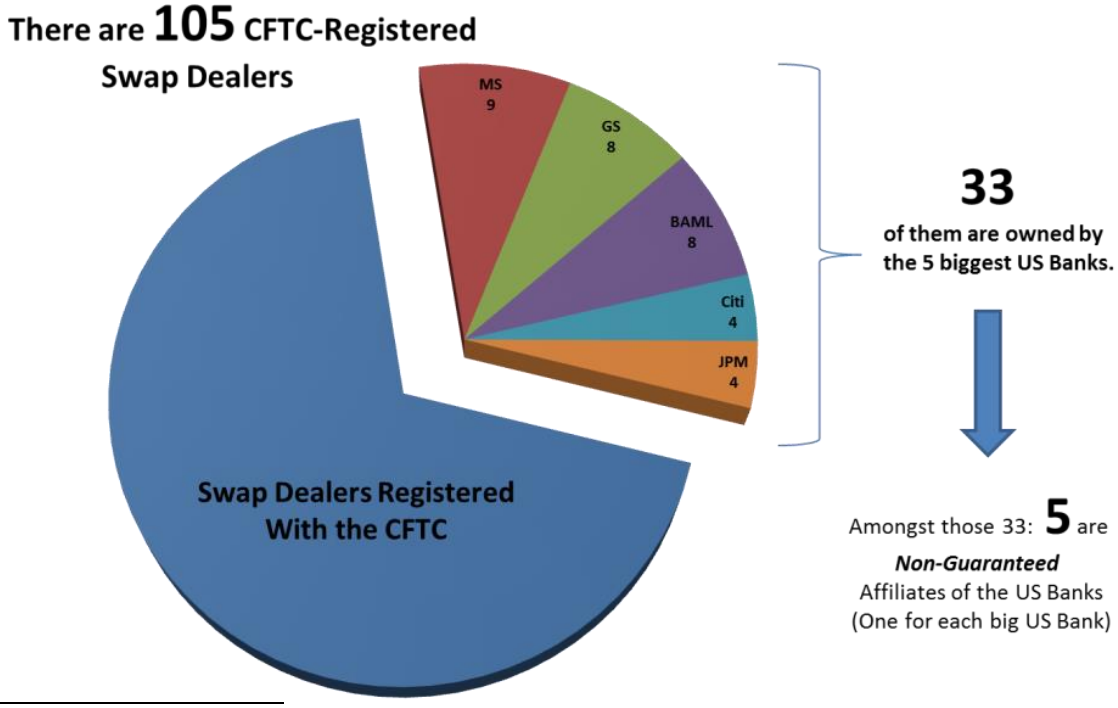
Cross-Border Factsheet:

U.S. Banks Are Again Trying to Evade the Financial Reform Law by Changing a Few Words in a Contract; this Time, it's Called "De-guaranteeing" Overseas Affiliates

The Issue:

If foreign affiliates of U.S. banks are not fully regulated under the cross-border rules by the SEC and the CFTC, the result will be an enormous loophole that will allow Wall Street's biggest banks to evade critical financial reform protections designed to prevent another financial crisis and more bailouts.[1] If this happens, Wall Street's banks will merely move their derivatives business overseas to avoid U.S. rules. The U.S. will lose – and foreign countries will gain – the employment and tax revenue from that business. Wall Street will again enjoy billions of dollars in bonuses. But, the U.S. and U.S. taxpayers will still get the bailout bill when those derivatives blow up and banks begin to collapse, just as AIG and so many others did in 2008.

The CFTC proposed rule allows Wall Street's biggest banks to evade critically important financial reform rules by simply changing a few words in their derivatives contracts, which they are already doing. It is called "de-guaranteeing" and it is the ultimate example of **form over substance**. U.S. banks merely create a foreign subsidiary without the word "guarantee" and then claim it is not guaranteed by the bank and, voila, their trades are not subject to U.S. regulations. However, as recent history has proved, there is often no meaningful difference between foreign entities with or without explicit guarantees: the market knows and relies on the unstated fact that the U.S. parent bank can and ultimately must bail out any purportedly



[1] The SEC rules do not cover either "guaranteed" or "unguaranteed" foreign affiliates of U.S. banks; the CFTC rules cover "guaranteed" but not "unguaranteed" foreign affiliates of U.S. banks.

unguaranteed subsidiaries to avoid the reputational and run risk associated with their failure.

By making these cosmetic technical changes to their contracts, banks are again moving their risky derivatives trading offshore and outside U.S. regulation, while increasing the risk that future losses will still come back home to the U.S. for U.S. taxpayer bailouts – just as they did in 2008.

In prior comment letters and meetings, Better Markets warned the regulators that U.S. banks would do precisely this, and now the CFTC and SEC must take swift action to stop this evasion.

What is a guaranteed affiliate?

U.S.-based banks often set up affiliate entities in foreign countries to act as the U.S. bank's counterparty to foreign swap transactions. These foreign-based affiliated entities can be structured by the U.S.-based bank with or without a guarantee from the U.S. parent bank.

When the U.S.-based bank structures the foreign affiliate with a guarantee, the counterparties to the U.S. bank's foreign affiliate rely on the creditworthiness of the guarantor (i.e., the U.S. bank) whenever doing business with the foreign affiliate. Because the U.S. bank guarantees the foreign affiliate, the foreign affiliate's counterparties consider themselves to be, in effect, dealing with the U.S. guarantor. Indeed, without the guarantee from the U.S. bank, the foreign affiliate would be considered entirely unsuitable to most, if not all, counterparties. That is to say, the counterparties only deal with the foreign affiliate because it is guaranteed by the U.S. bank, which will bail out, support, or otherwise stand behind the swap transactions with any counterparty to the guaranteed foreign affiliate.

For these reasons, the CFTC determined that foreign guaranteed affiliates of U.S. banks are entities that pose a risk to the U.S. because losses at the affiliate would flow back to the U.S. bank due to the guarantee. Therefore, swaps transactions under CFTC jurisdiction that are booked out of a foreign guaranteed affiliate of a U.S. bank are subject to many of the key protections of the financial reform law – including reporting and recordkeeping requirements, SEF rules, and clearing mandates.

Attempting to evade U.S. law, U.S. banks are removing the word "guarantee" from their express agreements with foreign affiliates

Recent reports have indicated that, in an effort to evade U.S. swap regulations, U.S. banks have begun to remove references to "guarantees" in the documents associated with their foreign affiliates, or are structuring new foreign affiliates without express guarantees. This is being referred to as the U.S. banks' "de-guaranteeing" their foreign affiliates (or, sometimes, certain of their transactions). However, merely removing the explicit or express guarantee likely does little if anything to remove the real liability of and risk to the U.S. bank because, although the word "guarantee" may be removed, these foreign affiliates will nonetheless be **de-facto guaranteed**, as was made clear during the 2008 financial crisis.

Which rules don't apply to unguaranteed affiliates?

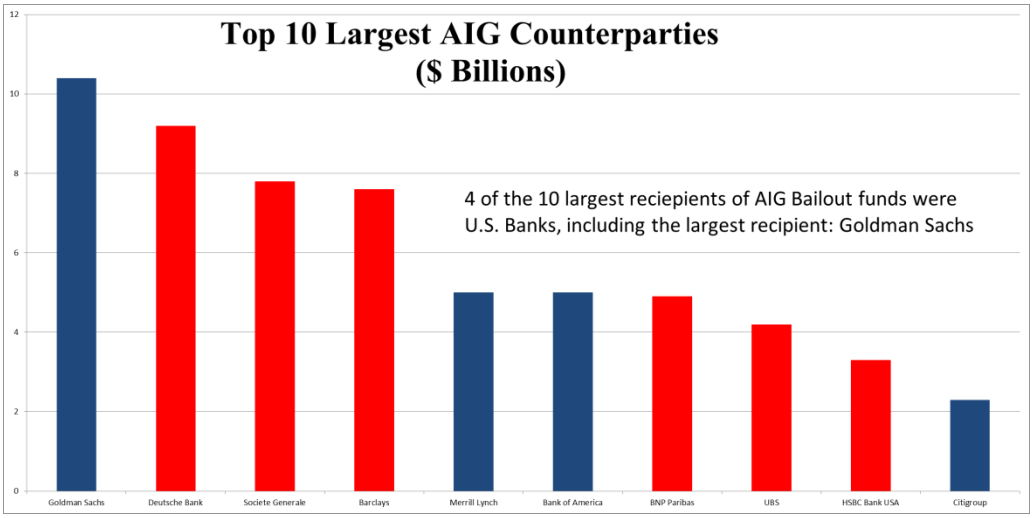
- SEF trading and Execution Rules
- Margin and Segregation Requirements
- Swap Reporting Rules
- Business Conduct Standards
- U.S. Clearing Requirements

For example, during the crisis, U.S. banks – like Citigroup – bailed out affiliates **even when they were not legally required to do so.** U.S. banks did this (and will do it again) because they face significant reputational risk due to the failure of an affiliate or sponsored entity. Counterparties, clients, and shareholders assume the U.S. bank will stand behind its affiliates since any failure to do so is interpreted as balance sheet weakness of the U.S. bank, thereby causing a run on the U.S. bank.

Citigroup is a classic example: During the financial crisis, to avoid failure of its **guaranteed** conduits, Citigroup bought $25 billion of commercial paper from them and placed them on the books of its commercial bank. Citigroup also "chose" to bring $49 billion of **unguaranteed** SIV assets onto its balance sheet, even though it had no legal obligation to do so. Citigroup was forced to recognize huge losses on these securities and other positions, which dramatically reduced its capital, helped to bring the company to the brink of failure, and required hundreds of billions of dollars in government bailouts. Ultimately, Citigroup required more total Federal rescue aid than any other single entity or firm in connection with the financial crisis ($476 billion). Its assumption of affiliates' losses, including from nominally unguaranteed affiliates, contributed to that.

Other transnational banks – including Barclays, HSBC, Dresdner, and Bank of Montreal – also moved SIV assets onto their balance sheets to avoid reputational damage. In fact, there is a long history of parent companies taking huge losses from the derivatives trading activities of their foreign subsidiaries and affiliates, including some of the most infamous debacles in recent financial history.

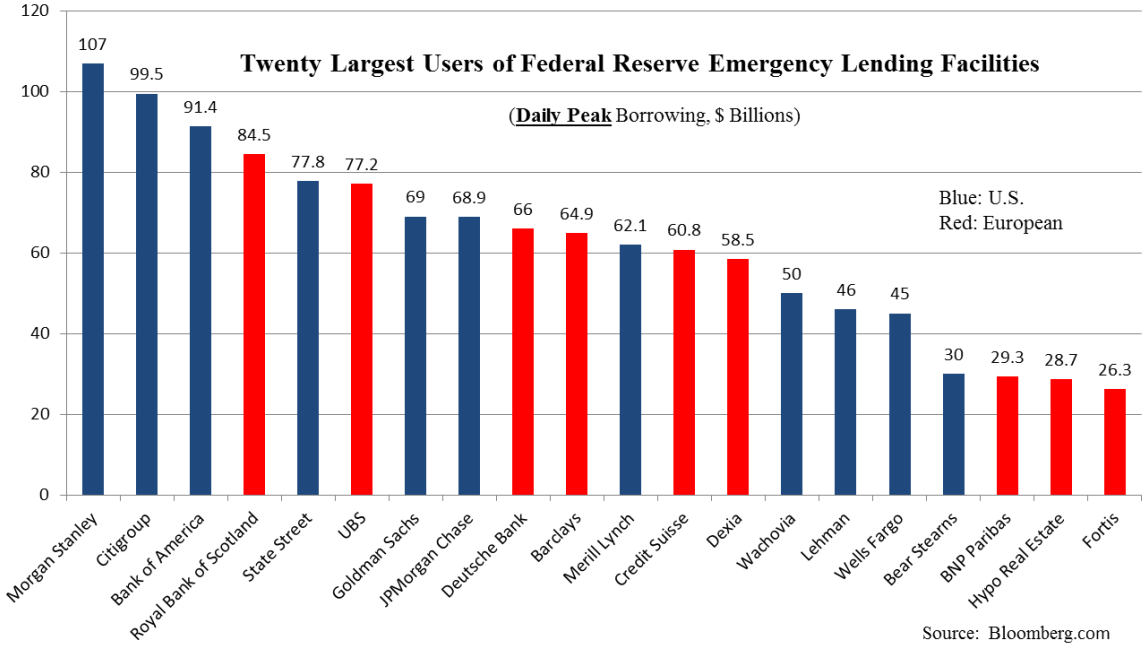
Probably the most famous, the American insurer AIG spectacularly lost billions and imperiled the global financial system when AIGFP, its French affiliate operating out of London, sold hundreds of billions of credit derivative contracts that suffered enormous losses during the 2008 financial crash. The U.S. government provided several bailouts to AIG totaling $185 billion, which was used to bail out its counterparties, including all the major international swap dealers (as shown on the attached chart).



Unguaranteed affiliates are *de facto* guaranteed by the parent – regardless of the nominal legal structure.

Despite the known fact that there is often no difference between a guaranteed and purportedly unguaranteed foreign affiliate, especially during a financial crisis and bank run, compliance with U.S. swaps rules often hinges to a large extent on whether or not there is an explicit "guarantee" of a foreign affiliate by a U.S. bank. While the CFTC's rules go substantially further than the SEC's, neither regime subjects these *de facto* guaranteed affiliates to important swap rules designed to protect U.S. taxpayers and the U.S. financial system from overseas activities that threaten U.S. banks, the U.S. banking system, and the entire economy as was evident in 2008-2009.

U.S. banks are simply removing their explicit guarantees of foreign affiliates swaps activities or books, while nonetheless benefiting from a *de facto* guarantee – thereby evading most oversight and regulation. How do we know this? First, the actions in the last crisis by big U.S. banks like Citigroup demonstrate that this happens and will happen again. Second, if those foreign affiliates were in fact not guaranteed *de facto* by the U.S. bank, then many, counterparties would stop doing business with them or there would be an observable material price difference between dealing with a guaranteed affiliate and a genuinely unguaranteed affiliate. If there is no difference in practice and/or price, that is evidence that a "de-guarantee" is no more than a **de-facto guarantee**, which is just a guarantee without the words but still with all the risks flowing back to the U.S..



Like last time, when all the major global swaps dealers required massive bailouts, losses from these unregulated de-facto guaranteed foreign entities will flow back to the U.S., putting our economy and taxpayers at grave risk again. U.S. banks should not be able to evade important regulations that protect the U.S. and U.S. taxpayers merely by simply changing a few words on a contract and allowing form to trump substance.

How can the cross-border rules be fixed to prevent this evasion?

The regulators must ensure that the term "guaranteed affiliate" is appropriately defined to include those affiliates that are simply ***de facto* guaranteed** regardless of an express guarantee agreement, **unless** the U.S. bank and its foreign affiliate pass the *de facto* guarantee test detailed below to ensure that there is no guarantee whatsoever. **Both pose the same significant risk of contagion to the U.S. bank guarantor in times of market stress.** Because of this connection to and reliance on the U.S. "guarantor," the *de facto* guaranteed entity should be classified as a "U.S. person" under both the SEC and CFTC regimes – or at least regulated to the same extent as explicitly guaranteed entities:

De facto Guarantee Test

1) Prohibit a foreign affiliate from using , incorporating, or referring to the parent's name (or variation of the name) in its own name or documentation, since such use raises an inference of support and gives rise to reputational and run risk to the parent U.S. bank.

2) Include in all trade documentation an explicit statement that the *de facto* guarantor will NOT provide resources, of any type, manner, or form however labeled, directly or indirectly, to the subsidiary other than in the ordinary course of business as established over time, accompanied by an explicit waiver by the counterparty of any claim of any type against the parent.

3) Require a public filing by the *de facto* guarantor committing and representing that it will not provide such resources to the subsidiary under any circumstances other than the ordinary course of business as established over time, and impose regulatory and private liability under all applicable anti-fraud and other laws in the event this commitment is breached.

Only foreign affiliates that meet **all** of these conditions can be considered unguaranteed and, therefore allowed to operate outside the important protections mandated by Dodd-Frank's Title VII swap rules.

However, even foreign entities that meet all of these requirements must be continually monitored over time to ensure that they act in fact as unguaranteed by a U.S. parent company, which shall be established by:

4) An observable, material price concession on those swaps that are unguaranteed.

If there is no such price concession, then this is concrete evidence that the market – and the entity's counterparties – believe that there is a *de facto* guarantee in place. In such a case, the nominally unguaranteed affiliates must be designated as U.S. persons to prevent evasion.

For more information, please contact press@BetterMarkets.com.