Dodd-Frank Title VII

Many new regulations, designed to prevent a recurrence of the last financial crisis, have had negative and unintended consequences for trade finance, potentially restricting its availability and increasing its cost. The US law commonly known as Dodd-Frank is one of these. A provision in Dodd-Frank has created a risk that market-standard funded and unfunded risk participations via Master Participation Agreements (MPAs) could be interpreted as swap agreements. This would result in very heavy additional requirements for affected banks, such as additional reporting which would make such agreements unfeasible. This is not just a US issue – it will affect everyone in this market directly or indirectly sooner or later.

Overview:

In August of 2012, the Agencies (SEC and CFTC ) issued a joint release aimed at defining a swap or security based swap in the context of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The release, among other things, addressed the status of loan participations as "Title VII Instruments".

Whilst the release provided much-needed certainty with respect to participations of funded assets on a funded basis (i.e. they would not be treated as a swap/security-based swaps), it did not provide the same degree of certainty for participations of funded assets sold on an unfunded basis even though these are also routinely subject to participation arrangements in the same secondary market.

The release stated that "for a loan participation to not be considered a swap or security-based swap, the loan participation must represent a current or future direct or indirect ownership interest in the loan or commitment that is the subject of the loan participation", and that such a loan participation should have four identified common characteristics (the "Participation Status Characteristics");

- The grantor of the loan participation is a lender under, or a participant or sub-participant in, the loan or commitment that is the subject of the loan participation.

- The aggregate participation in the loan or commitment that is the subject of the loan participation does not exceed the principal amount of such loan or commitment. Further, the loan participation does not grant, in the aggregate, to the participant in such loan participation a greater interest than the grantor holds in the loan or commitment that is the subject of the loan participation.

- The entire purchase price for the loan participation is paid in full when acquired and not financed (*"Full Payment Characteristic"*).

- The loan participation provides the participant all of the economic benefit and risk of the whole or part of the loan or commitment that is the subject of the loan participation.

Application of the *Full Payment Characteristic* is least clear when considered in relation to the distribution of unfunded participations in underlying assets that have already been funded by the Seller (i.e., unfunded risk participations in funded assets).

In the event that risk participations are deemed to be Security-Based Swaps, certain specific swap-related reporting requirements would be triggered. The record-keeping requirements would be lesser for a Bank Security-Based Swap Dealer (compared to a pure Swap Dealer), however these requirements are still quite elaborate. In addition, many of the record-keeping requirements demonstrate that they are clearly not aimed at (or truly applicable) to our market, as detailed in the following document issued by the SEC in May 2014:

Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers; Proposed Rules

Broadly speaking, affected banks may be required to comply with the same general recordkeeping and reporting requirements that already apply to broker-dealers, with certain enhancements and modifications to reflect the specific properties of Security-Based Swaps and requirements under the Dodd-Frank Act, should this matter not be resolved.

BAFT

In response to the issue and lack of clarity on the matter, and on behalf of its member banks, the industry body BAFT engaged Sullivan & Cromwell ("S&C", a US legal law firm) to review the potential impact of Dodd Frank Title VII on the trade finance risk distribution market. S&C sought clarification from the SEC and CFTC regarding Trade Finance Participations under Title VII in Sept 2013. The response from S&C to BAFT in Jan 2014 was unfortunately inconclusive.

Subsequently, the BAFT Legal Advisory Group (comprising members of the legal teams from certain BAFT member banks) has been working on a rider which could be inserted into the MPAs. Whilst the rider is unlikely to redress the issue in isolation (solely stating that a risk participation is not a Security-Based Swap is unlikely to be sufficient justification to a regulator), it may nevertheless help with lobbying efforts.

ITFA

ITFA is continuing to collate data from its members, plus other key non-member banks that are active in the trade finance risk distribution market. The purpose of the survey is to provide BAFT with some empirical evidence of the size and importance of risk distribution in the trade finance industry.

*** ACTION REQUIRED ***
**Banks who have not yet responded to the survey are strongly encouraged to do so in the interest of the industry as a whole.**

Please take a few moments to collect the following data and *feed it back directly to ITFA* via the following email address: info@itfa.org

- How many sub-participation agreements does your institution have in place by number?
- What approximately is the value of the transactions completed by your organisation during the last financial year under such agreements?
- What proportion of these transactions were unfunded?
- What proportion were unfunded participations in underlying funded assets?

*The information provided to ITFA for this survey will be treated confidentially. ITFA will collect the information and combine it with existing data which will be passed to BAFT only, to assist in lobbying the US authorities. No identifiable information for any organisation will be shared with any other party.*

Risk Distribution practitioners

In response to concerns being discussed within individual banks, a separate working group consisting of key members from the risk distribution teams in Barclays, Bank of America Merrill Lynch, Deutsche Bank, HSBC, JPMorgan, RBS have collectively reached out to BAFT in order to push for resolution on this matter.

The Risk Distribution practitioners originally sent a memo to BAFT in June 2014, detailing why all forms of Trade Participations, including unfunded participations in funded assets, should be treated as an identified banking product within the provisions of Section 403(a) of the Legal Certainty for Bank Products Act of 2000

as amended by Dodd-Frank and should not be treated as swaps under the Commodity Exchange Act or security-based swaps under the Securities Exchange Act of 1934, in each case as amended by Dodd-Frank.

The group has also subsequently provided responses to a set of specific queries that were addressed to the practitioners by BAFT on behalf of S&C.

Amongst others, the points put forward by the practitioners are that:

- The distribution functions are part of the trade finance origination business which they support; changing this because of Dodd-Frank would create significant issues for the trade finance business as a whole (both logistical and, consequently, cost implications);

- There are other existing forms of unfunded risk mitigation for trade finance transactions that work in a similar manner and yet are not potentially captured by Dodd-Frank, namely: trade facilitation programmes (e.g. either via SBLC or guarantee), and the use of insurance;

- If US banks are unable to distribute trade finance assets on an unfunded basis and non-US banks are still able to, then US banks will obviously be at a disadvantage. This will, in turn, impact US corporates requesting financing from their house banks in the US: trade finance customers operate globally, and often need to transact in jurisdictions where their local banks don't necessarily have capacity. If US banks are unable to distribute the risks they cannot accommodate, ultimately both the banks and their customers will be impacted.

- There is the additional risk that, pending any clarity on the matter, or if forced to report any transactions that may create an impractical or prohibitively costly reporting requirement, non-US banks will stop closing risk participations with any US nexus and will focus their activities on alternative markets and counterparties.

<u>Memo to the Banking Agencies</u>

In response to this latest initiative, BAFT in conjunction with its Legal Advisory Group and S&C, are keen to form an advocacy approach to the Federal Banking Agencies in order to clarify the treatment of the MPA under the Title VII banking product exemption.

S&C are therefore currently in the process of drafting a memo that will be submitted to the Banking Agencies on the Title VII banking product exemption issue for the MPA.

A participation in a loan is currently exempt from Title VII as the loans themselves are classified as a "Traditional Banking Product". Title VII does not go into further detail as to what the loan must look like, as long as the investor is an "eligible contract participant" (which broadly speaking captures FIs, NBFIs and other qualified/educated investors).

S&C are looking to present the similarities between trade finance products and other types of loans, to demonstrate to regulators by analogy that trade finance should not (in the context of Title VII) be treated differently to said loans. The argument is that whilst they have a different label, they are indeed analogous to existing loan products in many respects.