The World Bank
Washington, D.C. 20433
U.S.A.

Anne-Marie Leroy
Senior Vice President and Group General Counsel

October 5, 2011

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

International Bank for Reconstruction and Development
and International Finance Corporation –
Legal Opinion Regarding Privileges and Immunities

Dear Mr. Chairman:

We met with you and your staff on July 6, 2011 to discuss the special status under U.S. law of the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), and other multilateral development institutions in which the United States is a member (collectively, the MDBs). In particular, we urged the CFTC to implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) in a manner that (1) fully respects the privileges and immunities of IBRD, IFC, and other MDBs, as implemented in U.S. law, and (2) does not impair the development effectiveness of these institutions. We subsequently filed a July 22, 2011 comment on the proposed rule regarding the further definition of the term "swap", a copy of which is attached for your reference.

In our July 6 meeting, you asked if an external law firm had opined on this matter. IBRD and IFC subsequently commissioned the firm of Sullivan & Cromwell to analyze the potential application of the Dodd-Frank Act to our derivatives activities. The opinion was primarily prepared by Edwin Williamson, currently Senior Counsel to Sullivan & Cromwell and formerly the Legal Adviser of the U.S. Department of State. The Sullivan & Cromwell opinion, which is attached to this letter, confirms 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 organization, as implemented in U.S. law by the Bretton Woods Agreements Act and the International Finance Corporation Act. The opinion further concludes that the Dodd-Frank Act does not authorize any such curtailment of the privileges and immunities of IBRD and IFC.

The legal opinion is addressed to and focuses on the privileges and immunities of IBRD and IFC, the organizations that commissioned it. As noted in July 22, 2011 letter, all of the other MDBs (as defined therein) have equivalent privileges and immunities that

the US has agreed to accept (page 4) and which are implemented in U.S. law in the same manner as the privileges and immunities of IBRD and IFC (page 4, footnote 2).

As outlined in the July 22, 2011 letter, we continue to believe that one potentially efficient and effective mechanism for dealing with this issue is for the CFTC to define the term "swap" to exclude transactions with MDBs of which the United States is a member (subject to a potential exclusion that would ensure that our commercial counterparties still report any transactions with us to the CFTC).

At the same time, we remain open to other options that would provide a comprehensive solution to this issue – in particular, solutions that would deal with what the Sullivan & Cromwell opinion describes as prohibited "Direct Regulation Equivalent" measures such as mandatory collateralization and clearing requirements for our derivatives transactions.

Please feel free to share this letter with the staff of the CFTC as you see fit, and to make it part of the public record as necessary or desirable. We would welcome the opportunity to engage in further consultations about any other potential implementation options that the Commissioners or the CFTC staff believe would be appropriate in the circumstances.

Sincerely,

Anne-Marie Leroy
Senior Vice President and Group General Counsel

cc: Mr. Michael Dunn, CFTC Commissioner
Ms. Jill E. Sommers, CFTC Commissioner
Mr. Bart Chilton, CFTC Commissioner
Mr. Scott D. O'Malia, CFTC Commissioner
Mr. Ian Solomon, Executive Director for the United States of America, World Bank
Mr. Vincenzo La Via, World Bank Group Chief Financial Officer
Ms. Madelyn Antoncic, Vice President and Treasurer, World Bank
Ms. Rachel Robbins, Vice President and General Counsel, IFC
Mr. Jingdong Hua, Vice President, Treasury and Information Technology, International Finance Corporation
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Mr. Pierre Van Peteghem, Group Treasurer, African Development Bank
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Ms. Isabelle Laurent, Deputy Treasurer & Head of Funding, European Bank for Reconstruction & Development
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Re: Privileges and Immunities of the International Bank for Reconstruction and Development and the International Finance Corporation

Dear Ms. Leroy and Ms. Robbins:

You have asked us whether the application to the International Bank for Reconstruction and Development ("IBRD") and the International Finance Corporation ("IFC") (collectively, the "Organizations") and the derivatives transactions to which they are a party ("swaps") of the regulations proposed or adopted by the Commodity Futures Trading Commission ("CFTC")[1] implementing Title VII of the Dodd-Frank Act (17 C.F.R. Parts 1, 23, 41, 190, 240) (the "Regulations") would violate the privileges and immunities provided to the Organizations by their respective Articles of Agreement and implemented as U.S. domestic law by the Bretton Woods Agreements Act in 1945

1 Because we understand that the Organizations do not engage in "security-based swaps", we are only addressing regulation by the CFTC. Were the Organizations to engage in "security-based swaps", our conclusions would also apply to the counterpart "security-based swaps" regulations of the Securities and Exchange Commission.

(22 U.S.C. § 286 (2006)) and the International Finance Corporation Act in 1955 (22 U.S.C. § 282 (2006)) (the "Implementing Legislation").

For the reasons and subject to the discussion below, in our opinion, such application of the Regulations would be a breach by the United States of its obligations under the Articles of Agreement. Furthermore, the effect of the Implementing Legislation is to prohibit any curtailment of the IBRD's and the IFC's privileges and immunities provided by the Articles of Agreement, in the absence of legislation authorizing such curtailment. The Dodd-Frank Act does not contain any such provision, express or implied.

I. The Basis of the Organizations' Privileges and Immunities

A. The Articles of Agreement and the Implementing Legislation

Article VII of the IBRD Articles of Agreement and Article VI of the IFC Articles of Agreement include the following privileges and immunities: (i) immunity from suit by or on behalf of member states (Section 3 of Articles VII and VI) ("immunity from members' suits"), (ii) immunity from attachment prior to entry of a final judgment (Section 3) ("attachment immunity"), (iii) immunity of their property and assets from "search, requisition, confiscation, expropriation or seizure *by executive or legislative action*" (Section 4) ("immunity from seizure"), (iv) inviolability of their archives (Section 5) ("archival immunity") and (v) "to the extent necessary to carry out the operations [of the Organizations as] provided for in" their respective Articles of Agreement, freedom of their property and assets from "*restrictions*, *regulations*, *controls* and moratoria of any nature" (Section 6) ("regulatory immunity") (emphasis added). The express purpose of the privileges and immunities is "to enable the [Organizations] to fulfill the functions with which [they are] entrusted...." (Section 1 of IBRD Article VII and IFC Article VI.)

The Articles of Agreement obligate all member governments to accept and implement the privileges and immunities espoused in the Articles of Agreement into domestic law (Section 10 of IBRD Article VII and IFC Article VI). The United States executed these obligations by passing the Implementing Legislation, which expressly provides that the Articles of Agreement have "full force and effect in the United States and its Territories and possessions" (22 U.S.C. § 286(h) (2006); 22 U.S.C. § 282(g) (2006)).

B. The International Organizations Immunity Act

The International Organizations Immunity Act ("IOIA") provides that the property and assets of international organizations designated by the President of the United States "shall enjoy the same immunity from suit and every form of judicial process as is enjoyed by foreign governments" and "shall be immune from search" and "confiscation" (22 U.S.C. §288a(b),(c)). It also provides that the archives of such organizations are inviolable. Id. The Organizations have been designated by the President as enjoying the provisions of the IOIA (Exec. Order No. 9751, 3 C.F.R. 558 (1943–1948; Exec. Order No. 10,680, 21 Fed. Reg. 7,647 (Oct. 2, 1956)).

The IOIA is not as broad as the Articles of Agreement and the Implementing Legislation in its grant of privileges and immunities. It does, however, supplement and reinforce certain of the privileges and immunities accorded to the Organizations under their Articles of Agreement and the Implementing Legislation. To the extent that the provisions of IOIA and the Articles of Agreement are not identical, the Organizations enjoy the benefits of both (Restatement of the Foreign Relations Law of the U.S., § 467, comment f (1988)). Thus, interpretations of the IOIA are instructive in understanding the privileges and immunities accorded by the Articles of Agreement. The IOIA immunities may be denied by Presidential action, but the President does not have similar authority under the Articles of Agreement and the Implementing Legislation.

C. Purposes of the Privileges and Immunities

The premises on which the Organizations' immunities – and indeed, the Articles of Agreement as a whole – are based are that (i) some measure of immunity from the legislation and application of individual sovereign rules is necessary if the Organizations are to effectively operate in an international environment and fulfill their development missions and (ii) the Articles of Agreement create a single collective governance system through which the sovereign members of the Organizations control the Organizations and through which appropriate rules and practices, such as financial controls, employment rules and financial disclosure practices, are imposed by the members. As the largest shareholder and capital contributor of the Organizations, the United States plays a very important role within this structure.

Consistent with these premises, the Organizations have functioned for decades free from national regulatory regimes. The United States has confirmed on several occasions that the Organizations are not subject to U.S. financial regulations: (i) the securities of the Organizations are not subject to the provisions of the Securities

Act of 1933 and the Securities Exchange Act of 1934 (22 U.S.C. § 282k(a) (2006); 22 U.S.C. § 286k-1(a) (2006)); (ii) the staff of the Securities and Exchange Commission ("SEC") has confirmed that the status of the IFC under its Articles of Agreement "is obviously completely inconsistent with the broad jurisdiction" of the SEC under the Investment Company Act of 1940 (Memorandum from the Division of Corporate Regulation to the SEC Re: Applicability of the Investment Company Act of 1940 to the International Finance Corporation (May 10, 1955) (on file with the SEC)); and (iii) the SEC has confirmed that the IBRD and the International Development Agency "are persons not within the intent" of the Investment Advisers Act of 1940's definition of "investment adviser" (Investment Advisers Act of 1940 Release No. 1971, 2001 SEC LEXIS 1782 (Sept. 4, 2001)). The European Commission has similarly exempted the Organizations from the reach of its Prospectus Directive and Transparency Directives (Council Directive 2003/71, para. 11, 2003 O.J. (L 345) (EC); Council Directive 2004/109, art. 8, 2004 O.J. (L 390) (EC)), as have the European Parliament and Council in the Alternative Investment Fund Managers Directive (Council and Parliament Directive 2011/61, art. 2, 2011 O.J. (L 174)).

Although there are relatively few court decisions interpreting the scope of the privileges and immunities of international organizations, and we have not found a case that is directly on point with the facts and circumstances that you have asked us to consider, the privileges and immunities of international organizations have been considered by courts and the executive branch in other regulatory contexts. For example, courts and the executive branch have confirmed that national employment laws do not apply to the Organizations. In Mendaro v. World Bank, 717 F.2d 610 (D.C. Cir. 1983), the court held that the IBRD was immune from an employment related suit under the IOIA. The court cited approvingly a 1980 letter from the State Department Legal Adviser to the General Counsel of the Equal Employment Opportunities Commission. Id. at 620. That letter stated: "[T]here has emerged a widespread practice among States not to exercise jurisdiction over internal employment disputes in international organizations, regardless of whether national law specifically provides for immunity from jurisdiction...[o]ur own practice ... has been in accord with this principle, and I believe that it is incumbent on the U.S. Government to ensure that it remains so." (Marian L. Nash, *U.S. Practice*, 74 A.J.I.L. 917, 919-20 (1980)). The Mendaro court also relied on its decision in Herbert Harvey, Inc. v. NLRB, 424 F.2d 770 (D.C. Cir. 1969), in which the court acknowledged the IBRD's immunity from the jurisdiction of the National Labor Relations Board, in holding that a supplier of maintenance building services was nevertheless subject to the NLRB's jurisdiction, because the employees were not "intimately connected" to the IBRD's operations. The court's opinion suggests that, had the supplier supplied services that were "connect[ed] with the functions of the World

Bank as an investment institution", both it and the NLRB would have found that the supplier was not subject to the NLRB's jurisdiction because of the IBRD's immunity. Id. at 782.

A key element in the rationale underlying the conclusions in the authorities cited in the previous paragraph is the necessity that international organizations be free from hindrance by individual member states. In holding the Organization of American States immune from an employment contract claim in Broadbent v. OAS, 628 F.2d 27 (D.C. Cir. 1976), the court said: "[t]he United States has accepted without qualification the principles that international organizations must be free to perform their functions and *that no member state may take action to hinder the organization. . . .* Undercutting uniformity in the application of staff rules or regulations would undermine the ability of the organization to function effectively." Id. at 34-35 (emphasis added). In supporting its holding, along this same line of reasoning, the Mendaro court included the following quotation from the State Department Legal Adviser's letter referred to in the preceding paragraph: "Forcing the organizations to conform their personnel practices to the varying – and often conflicting – domestic laws in each country where they operate would create unmanageable administrative burdens and could well prevent them from carrying out the functions for which they were created." Mendaro, 717 F.2d at 617.

II. The Dodd-Frank Act Does Not Repeal or Provide Authority for the Curtailment of the Organizations' Privileges and Immunities

A. Canons of Statutory Interpretation Dictate that Repeal or Curtailment of Privileges and Immunities Must Be Explicit

The Organizations' privileges and immunities are established by their Articles of Agreement, which are international agreements to which the United States is a party. They have been made part of the domestic law of the United States by an act of Congress. The relevant canons of statutory interpretation compel the conclusion that the Dodd-Frank Act did not, and it did not authorize the CFTC to, repeal or curtail the Organizations' privileges and immunities found in the Articles of Agreement.

1. *Generalia specialibus non derogant* ("the general do not derogate from the specific") is a long-recognized canon of statutory interpretation. It essentially holds that if a later general law and an earlier specific law are potentially in conflict, courts will adopt the reading that does not result in an implied repeal of the earlier statute absent an express indication that the legislature intended to repeal the earlier law. In Ex Parte Crow Dog, 109 U.S. 556, 572 (1883) (superseded by statute on other grounds), the United

States Supreme Court held that a subsequent treaty with Native Americans did not repeal a prior law that excepted Native Americans from the jurisdiction of U.S. courts for specified acts, since the subsequent treaty did not repeal the prior statute through express words or necessary implication. The court explained that "[t]o find [that the later treaty repealed the more specific prior statute] would be to reverse in this instance the general policy of the government towards the [Native Americans], as declared in many statutes and treaties, and recognized in many decisions of this court, from the beginning to the present time. To justify such a departure, in such a case, requires a clear expression of the intention of Congress, and that we have not been able to find." Id.

Another example of the application of this canon can be found in General Electric Credit Corp. v. James Talcott, Inc., 271 F. Supp. 699 (S.D.N.Y. 1966), which held that the venue rules under the later adopted Securities Act of 1933 and the Securities Exchange Act of 1934 do not apply to national banks, which are governed by the more specific venue rules of the National Bank Act, since (i) there is a presumption against implied repeals, (ii) a special earlier statute is deemed to remain in existence as an exception to a later inconsistent more general statute and (iii) no irreconcilable conflict existed between the two venue statutes if the prior canon of statutory interpretation were applied.

Thus, the Organizations' specific privileges and immunities must be read as exceptions to the reach of the later adopted Dodd-Frank Act's general and broad provisions that, read literally, seemingly would require the regulation of all entities engaging in derivative transactions. Any other conclusion would amount to an implied repeal of the Organizations' immunities, a violation of the *generalia specialibus non derogant* maxim, given that the conflict between the seemingly expansive reach of the Dodd-Frank Act and the expressly provided privileges and immunities of the Organizations is irreconcilable. To paraphrase Ex Parte Crow Dog, a finding that the later enacted general Dodd-Frank Act effectively repeals, or authorizes the CFTC to repeal, a more specific prior law "would be to reverse in this instance the general policy of the government towards [the Organizations] from the beginning to the present time." 109 U.S. at 572. As discussed in more detail below, Congress has not expressed a clear intention, in either the text of Title VII or its legislative history, to do so.

2. The "*Charming Betsy* canon" holds that "[A]n act of Congress ought never to be construed to violate the law of nations if any other possible construction remains" (McCullough v. Sociedad Nacional de Marineros de Honduras, 372 U.S. 10, 19 (1963) (quoting Murray v. Schooner Charming Betsy, 6 U.S. 64, 118 (1804))). The Restatement of the Foreign Relations Law of the U.S., §114 (1988) formulates the

Charming Betsy canon this way: "Where fairly possible, a United States statute is to be construed so as not to conflict with international law or with an international agreement of the United States." In McCullough, the United States Supreme Court used this canon of interpretation to hold that federal law did not apply to a foreign vessel with American contacts where (i) a well-established rule of international law would require that a different law control, (ii) no language existed in either the federal act itself or in its "extensive legislative history" that reflected an intent to apply the federal law to foreign vessels and (iii) questions of international import would remain as to invite retaliatory action from other sovereigns if the federal law were applied. McCullough, 372 U.S. at 19-22.

* * *

Thus, in the absence of any indication that Congress intended otherwise, the Dodd-Frank Act must not be interpreted in a way that would result in the violation of the domestic law of the United States established by the Implementing Legislation or in the violation by the United States of its international law obligations contained in the Organizations' Articles of Agreement.

B. There is No Indication that the Dodd-Frank Act was Intended to Apply to the Organizations, Either Directly or Indirectly

The legislative history of Title VII and the historical national and international treatment of the Organizations suggest that Title VII should not apply to them. The record is void of any indication that Congress intended for Title VII of the Dodd-Frank Act to apply to the Organizations. Nothing in either the text of Title VII or its copious legislative history suggests a concern about regulating such entities. While the legislative history contains sporadic references to "international implementation" of the provisions of Title VII, the discussions appear to be more concerned with large, international, for-profit financial institutions rather than development institutions, such as the Organizations, that are owned by sovereign states. To the extent that the IBRD is ever referred to, it is only to mention it for its beneficial purpose. (Senator Dodd referred to the IBRD as "provid[ing] financial assistance and stability to nations that are struggling" in the context of speaking about *the fiscal irresponsibility of others* (111 Cong. Rec. S3860 (daily ed. May 18, 2010)).) Were there congressional intent to apply Title VII to the Organizations, such intent should have been expressly included in the Dodd-Frank Act itself and, we would expect, an explicit reference of such application to the IBRD or the IFC would have been expressed during the course of legislative deliberations.

While the text of Title VII also refers to the need for consistent "international implementation" of swaps regulation, this requirement as espoused in Section 752(a) of the Dodd-Frank Act lends further support to the proposition that Title VII should not apply to the Organizations. Section 752(a) of the Dodd-Frank Act requires the CFTC and the SEC to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation ... of swaps [and] security based swaps." The European Commission, however, has already considered the applicability of national derivative regulation to the Organizations in proposed legislation. Having done so, it concluded that such regulations should not apply to entities such as the Organizations, and it expressly provided that its European Market Infrastructure Regulation[2] – the European counterpart to Title VII – shall not apply to such entities "in order to avoid limiting their powers to intervene to stabilise [sic] the market, if and when required." (Explanatory Memorandum on Commission Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories, COM (2010) 484 (final) (Sept. 15, 2010).)

III. The Organizations' Purposes and Uses of Derivatives

The Organizations exist to promote economic development in their member countries. Envisioned at the Bretton Woods Conference in 1944 and established in 1945, the focus of the IBRD is on providing financing to its sovereign member countries. In 1956, the IFC was established with the stated goal of furthering economic development in the private sector through investments and other activities in the developing world. To realize their objectives, the Organizations employ a number of tools, including direct lending in major and local currencies, investing in equity in private sector enterprises and mobilizing from the private sector in order to supplement direct investment by the Organizations.

You have informed us that the Organizations use over-the-counter ("OTC") derivatives to hedge currency, interest rate and other market risks arising in connection with their lending, borrowing, equity management and investment operations, and to enable clients in developing countries and other official sector institutions to

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2 The European Commission's Regulation is currently pending before the European Parliament and the Council of the European Union.

manage the risks to which they are exposed as a result of their activities.[3] For example, the Organizations are able to borrow in currencies and interest bases that offer the lowest possible cost. Typically, interest rate or currency derivatives are used to hedge these liabilities into floating rate dollars, the basis on which the Organizations manage their assets. Interest rate and currency derivatives are used by the Organizations to manage their liquidity and for asset/liability management (e.g., to hedge mismatches between their floating rate dollar balance sheets and lending operations conducted in both major and emerging market currencies and at fixed and floating rates of interest). In furtherance of the Organizations' development objectives, they also make hedging tools available to their sovereign and private sector clients, doing so by engaging in back-to-back principal transactions that allow the Organizations to take the credit risk of their clients and bridge the credit gap preventing their clients from obtaining direct access to hedging markets, while simultaneously hedging any associated market risk with major international banks and swap dealers. These risk management transactions are part of a comprehensive suite of development financing tools that, in your view, are integral to the development operations of the Organizations, both as part of the Organizations' own tools for managing their funding, liquidity management and asset/liability management functions, and in providing needed access to financing strategies for the Organizations' sovereign and private sector clients. Indeed, you have advised us that, in your opinion, without access to derivatives markets, the Organizations could not operate effectively in a multi-currency, floating rate environment as they do today. The Organizations use derivatives for such hedging purposes as part of providing financing solutions to emerging market countries and do not engage in speculative transactions.

Furthermore, you advise, the Organizations have the necessary capabilities for managing the risks associated with over-the-counter derivatives, including transaction valuation tools and collateral management operations. In addition, both Organizations have established risk management procedures that set and monitor commercial counterparty credit exposure. The IBRD has been active in the derivatives market for three decades and has supported market initiatives to manage risk. Notably, both Organizations currently require even highly rated major market counterparties to collateralize trades undertaken with the Organizations. You have informed us that the strong practices of both Organizations have led them to be consistently rated as highly credit-worthy counterparties by credit rating agencies, and that banking regulators have

3 In rendering this opinion, we have relied, without independent verification, on information provided to us by the Organizations as to their swaps activities and the impact the application of the Regulations would have on their development missions.

consistently assigned low risk weightings to transactions with the Organizations under the Basel II framework.

A determination that the privileges and immunities of the Organizations do not insulate them from compliance with the provisions of the Dodd-Frank Act and the Regulations would impede the Organizations' abilities to effectively fulfill their functions by opening the door to the imposition of a multitude of national regulatory regimes on the Organizations. Regulation by several member states would inevitably result in conflicting regulation in many respects, which would hinder their ability to realize the international development objectives of their member governments, including the United States.

Finally, it is quite important to note that the Organizations are wholly owned by their sovereign shareholders; there are no equity shares held by individuals or financial institutions. Furthermore, there are no substantial bonuses or differential compensation arrangements that depend on financial performance. Thus, in your view, neither management nor staff of the Organizations has any individual or collective financial incentive to undertake undue risk.

IV. Application of the Regulations to the Organizations' Derivatives Would Violate their Privileges and Immunities

A. The Regulatory Scheme of the Regulations

There are basically two types of regulatory measures to which the Organizations and their swaps would be subject, were they to be covered by the Regulations, that would violate the Organizations' privileges and immunities:

1. *Direct Regulation of Entities under Title VII Based on Their Derivatives Activities ("Direct Regulation").* If the Organizations were covered by the Regulations, they could be required to register as "major swap participants" or "MSPs".[4] As an MSP, each would likely be required to, among other things:

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4 Given the status of the Regulations as of the date hereof, particularly the definition of "swap dealer", we are not able to conclude that the Organizations' activities would cause them to come within the definition of "swap dealer". The regulatory measures that would apply to the Organizations if they were required to register as "swap dealers" would create substantially the same conflicts with the Organizations' privileges and immunities as those that would be imposed on them as MSPs.

(a) Prepare and retain books and records in such manner and for such period as may be prescribed by the CFTC and submit to examinations and investigations by the CFTC;

(b) Maintain daily trading records (including records of oral and electronic communications and recording telephone calls);

(c) Post collateral as security for its swap obligations;

(d) Comply with capital requirements prescribed by the CFTC;

(e) Execute its swaps on a designated contract market or swap execution facility and clear them through a derivatives clearing organization;

(f) Conform to specific business conduct standards as adopted by the CFTC;

(g) Conform its swaps documentation to the standards proscribed by the CFTC; and

(h) Establish other practices that would be monitored by the CFTC.

Failure to comply with these measures, if they were applicable, would, of course, subject the Organizations to enforcement action.

2. *Regulation of Derivatives Entered into by the Organizations with Regulated Entities ("Direct Regulation Equivalent").* Even if the Organizations 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 and their swap transactions would be required to be executed on a designated contract market or swap execution facility and cleared through a derivatives clearing organization. The documentation would have to conform to standard documentation. 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.

B. Why the Regulations Would Violate the Organizations' Privileges and Immunities

Our conclusions set forth below as to the scope of the privileges and immunities of the Organizations in the context of the Regulations are based on our reading of the Organizations' respective Articles of Agreement, and our understanding of the policies underlying the scope and purposes of the privileges and immunities of international organizations generally, as illustrated in applicable court decisions and regulatory actions, as discussed in Section I.C.[5]

In our view, the books and records requirements, as well as the CFTC's examination and investigative powers, would violate the Organizations' archival immunity. Being subject to enforcement action would violate their immunity from members' suits, as well as their immunity from searches.

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.

While the Organizations' regulatory immunity may appear to be less absolute and perhaps more conditional than the other immunities found in the Articles of Agreement, because their regulatory immunity provides freedom from regulation only

5 In light of the scarcity of authority, and the absence of controlling authority in this specific context, the scope of the privileges and immunities of the Organizations in this context is not entirely free from doubt. Nevertheless, we believe that a court, if presented with a properly pleaded and argued case, should agree with our conclusions as to their scope.

"[t]o the extent necessary to carry out the operations provided for" in the Articles of Agreement, we do not believe that this is the case as applied to the context that you have asked us to consider. As the authorities cited in Section I.C indicate, a key element to the immunities is the necessity of avoiding the imposition by member states of regulations that could hinder the Organizations' abilities to accomplish their stated purposes. While those authorities cited were dealing with immunities that did not contain the "to the extent necessary" clause, we do not believe that difference is significant in this context. Because the imposition of regulations by one member state could lead to the imposition of additional, or varying or even conflicting, regulations by other member states, we believe that any regulatory measures that, while not necessarily prohibiting essential activities, increase the costs of such activities, reduce their effectiveness, adversely affect uses of capital or encourage other members to attempt to regulate or impose controls on the Organizations violate the Organizations' regulatory immunity.

In addition, you have informed us that compliance with many of the Regulations would come at a substantial cost of capital, personnel and time, causing the Organizations to divert resources intended for clients in the developing world. As an alternative, it might be necessary for the Organizations to remove themselves from the larger marketplace and transact wholly with other exempt entities or limit their activities to jurisdictions where their activities are not regulated, at a substantial cost to their ability to effectively manage risk due to the exponentially smaller universe of available counterparties. Other alternatives would be for the Organizations to limit lending activities, to the detriment of prospective borrowers and their development mission, or to discontinue providing risk management tools to borrowing countries and other clients, leaving them exposed to interest rate and currency risks. All of these options would impede the development effectiveness of the Organizations.

V. Regulation of the Organizations or Their Swaps is not Necessary

As we indicate in Section I.C, one of the premises on which the Organizations' privileges and immunities are based is that their Articles of Agreement create a single collective governance system through which the sovereign members of the Organizations control the Organizations and through which appropriate rules and practices are imposed by the members. The use of derivatives by the Organizations is authorized, monitored and controlled by their sovereign members, including the United States, in accordance with the organizations' operative documents. Thus, not only is there no need for a country-specific layer of regulation, but if the United States were to regulate the Organizations under the Dodd-Frank Act, it would open the door to other individual member states imposing their own regulations. This would undercut the

Organizations' governance system, which is based on the participation of each member government in the collective system as the exclusive method of governance.

For approximately thirty years, the Organizations have effectively managed their derivative operations independent of individual sovereign regulation. Given their history of responsible risk management, the fact that the Organizations' swaps are not regulated under Title VII would not create systemic risk or materially limit the CFTC's ability to regulate the market. (The Organizations' counterparties would, of course, continue to be regulated, to the extent that they are MSPs or swap dealers.) On the other hand, if the Organizations – both of which are very credit-worthy, responsible risk managers with strong capital structures backed by sovereign shareholders – are forced by the Regulations to withdraw from the larger swap market, it would leave fewer highly rated swap counterparties to transact with. Such a result may prove to be squarely inconsistent with Title VII's underlying concern about limiting systemic market risk.

It is also important to note that there is nothing to prevent the Organizations from voluntarily complying with provisions of Title VII, if the Organizations conclude that such actions are financially efficient and consistent with their development mandates. In any event, the history of responsible risk management by the Organizations and the overall mission of the Organizations helps to give comfort that the Organizations are unlikely to engage in the offending practices that Title VII was intended to curtail. Furthermore, the United States and the other member states, through their role in the Organizations' governance structures, should be able to prevent the Organizations' engagement in such practices.

With respect to Title VII's margin requirements, which you have advised us would be particularly burdensome to the Organizations, it is of note that each of the Organizations' ISDA agreements with counterparties, under which its swaps are entered into, contains a provision obligating the Organization to post collateral if its credit rating is downgraded below triple-A. (Currently, the Organizations are not required to post collateral.) Accordingly, the protections that Title VII seeks to impose in this regard are already built into the Organizations' contractual agreements. The Organizations' governance structures provide the member governments with a vehicle for maintaining these protective measures.

VI. Conclusion

The Direct Regulation and the Direct Regulation Equivalent measures may not apply to the Organizations or their swap transactions, because (i) such

application would be inconsistent with the Organizations' broad privileges and immunities provided in their Articles of Agreement, (ii) the United States has adopted implementing legislation giving full force to these privileges and immunities as domestic law of the United States and (iii) such application would violate the international obligations of the United States. Moreover, nothing in the text of Title VII of the Dodd-Frank Act or its extensive legislative history suggests that the Organizations or their swaps were intended to be subject to the requirements of Title VII. We also note your concern that inclusion of the Organizations and their swap transactions in the regulatory structure prescribed by the Dodd-Frank Act regarding derivative transactions is unnecessary in light of the governance structures of the Organizations, and that subjecting the Organizations or their swaps to regulation would likely have substantial negative consequences for the Organizations and their clients.

This opinion is addressed to you, is solely for your benefit and may not be relied upon by any other person without our express written consent.

Very truly yours,

SULLIVAN & CROMWELL LLP

The World Bank
Washington, D.C. 20433
U.S.A.

September 28, 2012

Mr. Michael Gibson, Co-Chair
Ms. Alexa Lam, Co-Chair
Working Group on Margining Requirements
Basel Committee on Banking Supervision
Board of the International Organization of Securities Commissions

International Bank for Reconstruction and Development,
International Finance Corporation, and
Other Multilateral Development Banks –
Comment on Consultative Document on
Margin Requirements for Non-Centrally Cleared Derivatives

Dear Mr. Gibson, Ms. Lam, and other Working Group members:

This comment is submitted by the International Bank for Reconstruction and Development ("IBRD" or "Bank") and the International Finance Corporation ("IFC") in respect of the Consultative Document issued in July 2012 by the Working Group on Margining Requirements (the "WGMR") of the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions entitled Margin Requirements for Non-Centrally Cleared Derivatives (the "Consultative Document"). IBRD and IFC are international, intergovernmental organizations formed, owned, and controlled by 188 and 184 sovereign members, respectively. IBRD and IFC use OTC derivatives to manage risk, and such transactions are critical for meeting the development purposes of each institution.

For the reasons described below, IBRD, IFC, and other multilateral development banks should be able to continue to negotiate margin arrangements on non-centrally cleared derivatives with their counterparties on a bilateral basis, rather than being subject to national regulation. In comments filed with the Commodity Futures Trading Commission in the United States in respect of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), we have repeatedly urged that new OTC derivatives regulations be implemented in a manner that (1) fully respects the privileges and immunities of IBRD, IFC, and other multilateral development institutions, and (2) does not impair the development effectiveness of these institutions. The same analysis should apply to the proposals set forth in the Consultative Document.

While this letter focuses on IBRD and IFC, it is being submitted on behalf of a group of multilateral development institutions (collectively, the "MDBs").[1] Moreover, while some of the specific examples provided below relate to IBRD and IFC operations and activities, the overall analysis applies to all MDBs – in particular, the consistent treatment of privileges and immunities. All of the MDBs share the same fundamental mission: to promote economic development and reduce poverty in developing and transition countries. Within the World Bank Group, IBRD provides loans to middle income countries, IFC provides loans to and makes equity investments in private sector entities across the developing world, International Development Association ("IDA") provides concessional lending in the form of credits and grants to the poorest countries, and the Multilateral Investment Guarantee Agency provides insurance for projects in developing countries. While the other MDBs have a regional focus, all of the MDBs work to promote better economic prospects for the billions of people who still live in poverty in developing and transition countries. The MDBs are a critical part of the post-World War II financial system created by the international community.

1. *The Favorable Treatment Accorded to Sovereigns and Central Banks in the Consultative Document Should Extend to IBRD, IFC, and other MDBs*

The Consultative Document discussed certain issues on which there was broad consensus within the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissioners ("IOSCO"), including the following conclusion:

> Similarly, the BCBS and IOSCO broadly supported not applying the margin requirements in a way that would require sovereigns or central banks to either collect or post margin. Both of these views are reflected by the effective exclusion of such transactions from the scope of margin requirements imposed in this consultative paper.[2]

IBRD, IFC, and the other MDBs should have the benefit of the same exclusion in the WGMR's final proposal. In our view, there is no reasonable basis for differentiating MDBs from sovereigns and central banks in respect of margin requirements for non-centrally-cleared derivatives. Indeed, to the extent that there are distinctions between MDBs and sovereigns and central banks, we believe that such distinctions provide an even stronger case for excluding MDBs from margin requirements.

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[1] This group includes 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.

[2] Consultative Document at page 9.

From a legal standpoint, as discussed in the next section, IBRD, IFC, and the other MDBs have the benefit of internationally recognized privileges and immunities. From a policy standpoint, as discussed in the following section, IBRD, IFC, and other MDBs present no systemic risk to the financial system, as reflected by high credit ratings, financial market valuations of MDB bond issues, and existing capital and credit risk rules imposed by prudential regulators and set by the BCBS itself. In the absence of any legal or policy basis for differentiating MDBs from sovereigns and central banks, we believe the WGMR's final proposal should extend the exclusion for sovereigns and central banks to MDBs.[3] We note that national and international regulators involved in proposing and adopting new derivatives regulations have provided exclusions from such regulations for sovereigns, central banks, and MDBs (sometimes defined as part of a larger category of international financial institutions), and we see no basis for applying an inconsistent treatment to MDBs in the case of margin rules.[4]

2. *The WGMR's Final Proposal Should Reflect the Privileges and Immunities of MDBs in Respect of Regulatory and Other Actions by National Regulators*

As described in more detail below, IBRD, IFC, and the other MDBs have the benefit of extensive privileges and immunities, reflected in the international agreements establishing each MDB and incorporated in national law in each member country. While we understand that the WGMR is only providing policy guidance that will need to be implemented by national regulators, we believe that the WGMR's final proposal should take into account the privileges and immunities of MDBs. In particular, the final proposal should not provide recommendations that conflict with the international legal obligations and domestic laws of the various countries to whom the WGMR's final proposal is addressed.

IBRD was established in 1945 and set the model for international development organizations. IBRD, IFC, and other MDBs are managed on a collective governance basis, as the most appropriate framework for international, intergovernmental organizations. In particular, the founding members recognized that being subject to regulation under a variety of potentially conflicting national laws and regulations would be inefficient at best, and crippling at worst.

[3] While official sector development institutions arguably do not fall within the definition of "covered entities" as set forth in the "Key principle" and "Proposed requirement" discussions on page 14 of the Consultative Document, we believe the most appropriate resolution is to provide an explicit, categorical exclusion for MDBs equivalent to that provided for sovereigns and central banks.

[4] *See, e.g.*, 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, OJ L 201/1 (also known as "EMIR"); U.S. Commodity Futures Trading Commission and Securities and Exchange Commission, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 77 Fed. Reg. 30,596 (May 23, 2012); U.S. Commodity Futures Trading Commission, End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012).

From the outset, sovereign members codified these principles by granting certain privileges and immunities to IBRD and IFC in their respective Articles of Agreement (and to other MDBs in their equivalent organizational agreements). These include immunity from regulation, requisition, expropriation, seizure, records inspection, and actions brought by member countries[5]. Each member country agrees to these privileges and immunities by adopting the Articles of Agreement or other constitutional document. Each member country further agrees to take whatever actions are necessary to make these privileges and immunities effective in their territories in terms of its own law. A detailed description of these privileges and immunities is set forth in Annex 1: Privileges and Immunities of IBRD, IFC, and Other MDBs.

The collective governance arrangement has stood the test of time. IBRD, IFC, and the other MDBs have been able to operate effectively and efficiently on a global basis with the benefit of both the privileges and immunities described above and with the understanding of member governments that national regulatory regimes were not intended to apply to the activities of international organizations. In the United States, the securities of IBRD and IFC are "exempted securities" under the Securities Act of 1933 and the Securities Act of 1934,[6] as are the securities of other MDB issuers. In 1955, the SEC confirmed in writing (immediately prior to the passage of the International Finance Corporation Act) that IFC (like IBRD before it) was not the type of organization that Congress intended to subject to regulation under the Investment Company Act of 1940. In 2001, the SEC exempted the IBRD and IDA from regulation under the Investment Advisers Act of 1940, for similar reasons.

The EU has a similar, consistent record of regulatory forbearance, expressly exempting MDBs from the recent Prospectus Directive and Transparency Directive. Perhaps more salient for the current discussion, the recently adopted EU Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (also known as the "EMIR") expressly excludes "multilateral development banks" such as IBRD and IFC from its coverage.

In response to a question raised by the Chairman of the U.S. Commodity Futures Trading Commission at a July 6, 2011 meeting, we commissioned the law 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.[7] 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

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[5] The immunity from suit by member countries is absolute, whereas the prevailing practice with respect to the immunity of sovereigns from suit is restricted and not available in, among other things, commercial transactions. See, e.g., U.S. Foreign Sovereign Immunities Act, 28 U.S.C. §1605(a)(2).

[6] *See* 22 U.S.C. §282k and 22 U.S.C. §286k-1.

[7] A copy of our transmittal letter and the Sullivan & Cromwell opinion is set forth as Attachment 1.

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 be reviewed in detail, certain sections of the opinion merit special emphasis in the context of the margining proposal 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 [Major Swap Participants], 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 – the subject under discussion in the WGMR's Consultative Document – 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.

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

The Sullivan & Cromwell opinion was limited to analysis of the facts, laws, and legal precedents prevailing in the United States. However, we note that all MDB member countries have agreed to the *identical* set of privileges and immunities and have taken whatever steps are necessary to make them effective as a matter of law in their own territories. We believe that the conclusions set forth above in respect of the U.S. legal system are generally applicable in other jurisdictions. Accordingly, the WGMR should exclude non-centrally-cleared derivatives transactions involving MDBs from margin requirements, in order to avoid a conflict with the international legal obligations and domestic laws of MDB member states.

3. *Under the Stated Objectives of the WGMR, There is no Basis for Imposing Margin Requirements on Non-Centrally-Cleared Derivatives of MDBs*

While the privileges and immunities argument set forth above should be dispositive, we also believe that margin requirements on non-centrally cleared derivatives transactions involving MDBs would not meaningfully contribute to the stated policy objectives of the WGMR. The Consultative Document identifies "two main benefits" for margin requirements for non-centrally-cleared swaps: (1) reduction of systemic risk, and (2) promotion of central clearing.[8] 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.

Systemic Risk: IBRD and IFC are highly credit-worthy entities. Indeed, the BCBS itself has consistently taken this view in setting capital requirements for transactions between regulated entities and MDBs. Under the Basel II standardized approach to credit risk, exposures to MDBs generally attract a zero percent risk weight. Moreover, under Basel II's internal ratings-based approach to credit risk, exposures to MDBs are not subject to the 0.03% probability of default floor.[9] The Basel III capital framework, currently under implementation, maintains both of these provisions.[10] Furthermore, securities issued by MDBs may be classified as "Level 1" High Quality Liquid Assets under the BCBS's Basel III liquidity guidelines.[11]

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[8] Consultative Document at page 2.

[9] *See* BCBS, International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version (June 2006), note 24 (listing MDBs eligible for zero percent risk weights).

[10] In their proposals to implement the Basel III capital framework in the United States, the U.S. federal banking agencies stated that a zero percent risk weight for exposures to MDBs 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." *See* Federal Reserve, FDIC and OCC, Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52,888 at 52,896 (Aug. 30, 2012).

[11] *See* BCBS, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (December 2010), paragraph 40(c).

Beyond the capital and liquidity standards set by the BCBS, there are a host of other indicators that MDB exposures do not present material risks to our counterparties or to the financial system as a whole. Our institutions carry the highest ratings issued by the major credit rating agencies. Moreover, the trading history of bonds issued by IBRD and IFC demonstrates broad market consensus that our institutions (and other MDBs) are among the safest credits in the capital markets. Furthermore, national regulators have taken the same approach in implementing the international Basel framework in their jurisdictions. For example, under the U.S. federal banking agencies' recent final rule to implement Basel 2.5 in the United States, banks using the standardized measurement method for specific risk may assign a zero percent specific risk-weighing factor to a debt position that is (or has) an (underlying) exposure to an MDB. [12]

Finally, it is worth noting that IBRD, IFC, and the other MDBs use derivatives 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. For a more detailed description of how MDBs use swaps, see Annex 2: Use of Derivatives by Multilateral Development Banks (MDBs). Moreover, while the MDBs play an important role in catalyzing development financing, the overall volume of their transactional activities relative to the market as a whole is relatively small.[13]

<u>Promotion of Central Clearing:</u> Regulators in major jurisdictions have already determined that MDBs will not be required to centrally clear derivatives.[14] The Consultative Document itself recognizes that there is no reason to impose margin requirements to promote clearing on entities whose swap transactions are already exempt from central clearing mandates under national regimes.[15]

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[12] In the preamble to their final rule to implement Basel 2.5 in the United States, the U.S. federal banking agencies stated that their decision to assign a zero percent specific risk-weighting factor to debt positions that are exposures to MDBs "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." *See* Federal Reserve, FDIC and OCC, Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53,060 at 53,077 (Aug. 30, 2012).

[13] 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 US 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 uncleared swaps with IBRD and IFC would be to require our institutions to post margin at a time when they present minimal or no risk to our counterparties.

[14] *See, e.g.*, 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, OJ L 201/1 (also known as "EMIR"); U.S. Commodity Futures Trading Commission, End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012).

[15] Consultative Document at page 9.

Under these circumstances, we see no basis under the stated policy objectives of the WGMR for imposing regulatory margin requirements on non-centrally-cleared derivatives transactions involving MDBs. Both the Basel Committee on Banking Supervision and many of the regulators represented on the WGMR have already determined that credit exposures to MDBs present no material risk to our counterparties or to the financial system as a whole – let alone the type of "systemic risk" that the margin proposal is designed to mitigate. Furthermore, there is no point to imposing margin requirements to promote central clearing when regulators have already determined that transactions by MDBs should be exempt from such clearing requirements.

4. *Margin Requirements on Non-Centrally-Cleared Derivatives Transactions of MDBs Would Impair the Development Effectiveness of Our Institutions*

While imposition of margin requirements on non-centrally-cleared derivatives of MDBs would not meaningfully impact systemic risk, it would impair the development effectiveness of our institutions. 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 a central bank. While some (but not all) MDBs have callable capital, even those MDBs with callable capital backing cannot call it for purposes other than servicing their respective 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 IDA, the concessional lending arm of the World Bank Group. Many of the countries that have been the strongest supporters of IBRD transfers to IDA are represented on the WGMR.

Some other potential implications are more difficult to quantify, but may be more serious over the long term. At the request of our member governments, 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 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 uncleared 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. We believe such an outcome would frustrate the development objectives of the MDB member countries that are represented on the WGMR.

5. *Conclusion*

IBRD, IFC, and other MDBs use derivatives in a responsible manner, subject to appropriate risk management measures and under the oversight of sovereign shareholders. As recognized by national prudential regulators and the international Basel capital and liquidity frameworks, exposures to MDBs do not present significant risks to individual counterparties or to the financial market as a whole. Moreover, the collective governance mechanism for international organizations has worked well for over 65 years. The WGMR's final proposal should exclude transactions involving MDBs from margin requirements. Such a result would respect the international legal obligations of member countries regarding the privileges and immunities of MDBs.

Sincerely,

Anne-Marie Leroy
Senior Vice President and Group General Counsel

Rachel J Robbins

Rachel Robbins
Vice President and General Counsel, IFC

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.[16]

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.

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[16] *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).

Annex 2: Use of Derivatives by Multilateral Development Banks (MDBs)[17]

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.[18] 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

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[17] 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.

[18] 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.

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.