March 15, 2013

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Submitted via electronic mail

Re: Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions Second Consultative Document Regarding Margin Requirements for Non-Centrally Cleared Derivatives

The undersigned group of captive finance[1] companies[2] is pleased to provide comments to the Basel Committee on Banking Supervision ("Basel Committee") and the International Organization of Securities Commissions ("IOSCO") regarding its Second Consultative Document ("Second Consultative Document") entitled, "Margin Requirements for Non-Centrally Cleared Derivatives."[3] The Second Consultative Document represents the "near-final policy framework" for the establishment of global minimum standards for margin requirements for non-centrally cleared derivatives.[4]

The Second Consultative Document reflects careful consideration of the responses received to the First Consultative Document, issued in July 2012.[5] The companies providing

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[1] A "captive finance" company refers to an entity whose primary mission is to provide financial products that promote and facilitate the sale or lease of products manufactured by their parent companies. Captive finance companies use derivatives for the sole purpose of hedging and mitigating underlying commercial risk related to interest rate or foreign currency exposures associated with financing their parent companies' businesses. In almost all respects, the funding and hedging activities of a captive finance company are analogous to the treasury division or department of a manufacturing company that is a non-financial, commercial end-user.

[2] Boeing Capital Corporation, Caterpillar Financial Services Corporation, Deere & Company, Ford Motor Credit Company, American Honda Finance Corporation, Nissan Motor Acceptance Corporation, Toyota Financial Services, and Volvo Financial Services Region the Americas. Volvo Financial Services Region the Americas was not a signatory to the Initial Comments.

[3] Bank for International Settlements. "Margin Requirements for Non-Centrally Cleared Derivatives" (February 2013), ISBN web: 92-9197-267-3. *See* http://www.bis.org/publ/bcbs242.pdf.

[4] *Ibid*, p. 1.

[5] Bank for International Settlements. "Margin Requirements for Non-Centrally-Cleared Derivatives" (July 2012), ISBN web: 92-9197-142-1. *See* http://www.bis.org/publ/bcbs226.pdf.

comments here previously submitted comments ("Initial Comments") to the First Consultative Document, which comments can be found on the Bank for International Settlements website[6] and are incorporated herein by reference.

We welcome the opportunity to provide comments on the Second Consultative Document.

We note that the Second Consultative Document announces, for the first time, that the entities subject to the framework will be largely determined by national regulation.[7] We would therefore like to take this opportunity to point out to the Basel Committee and IOSCO that U.S. regulators have chosen to treat captive finance companies as non-financial entities with respect to the mandatory clearing of swaps, and that the U.S. Congress has stated that captive finance companies do not pose systemic risk.

Because captive finance companies meet both criteria identified in the Second Consultative Document for an exemption from margin requirements for uncleared swaps – i.e., no systemic risk and no central clearing mandate – we would like to reiterate our request that the Basel Committee and IOSCO confirm that swaps entered into by captive finance companies are not subject to margin requirements. In the alternative, we request that the Basel Committee and IOSCO clarify that the determination as to whether an entity is a "financial entity" under national regulation is based on whether it is a "financial entity" for the purpose of qualifying for an exemption from the mandatory clearing requirement.

Additionally, it is critical that the Basel Committee and IOSCO continue to promote and work with national regulators to ensure harmonization of this framework. Harmonization is critically important across regimes including defining which entities and types of derivatives are subject to margin requirements. Without harmonization, the application of this framework could apply differently in separate jurisdictions.

<u>The Second Consultative Document</u>

The Second Consultative Document rightly confirms the framework advanced previously that non-financial entities, which do not pose systemic risk and are not required under their national regime to centrally clear their swaps, should not be required to post margin. Indeed, Element 2(c) states:

> "The BCBS and IOSCO believe that the margin requirements need not apply to non-centrally cleared derivatives to which non-financial entities that are not systemically-important are a party, given that (i) such transactions are viewed as posing *little or no systemic risk* and (ii) such transactions are *exempt from central clearing mandates* under most national regimes (emphasis added)."[8]

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[6] http://www.bis.org/publ/bcbs226/cfc.pdf.
[7] See page 9 of the Second Consultative Document.
[8] See page 7 of the Second Consultative Document.

We are pleased the Second Consultative Document recognizes that transactions involving non-financial entities (i.e., commercial end-users) should not be subject to margin requirements because such transactions do not pose systemic risk and are generally not required to be centrally-cleared, which is the case in the United States as well.

In determining which entities are considered non-financial and/or systemically important, we note that the Second Consultative Document looks to "appropriate national regulation." Element 2.6 states:

> "The precise definition of financial firms, non-financial firms and systemically important non-financial firms *will be determined by appropriate national regulation*. Only non-centrally cleared derivative transactions between two covered entities are governed by the requirements of this paper (emphasis added)."[9]

U.S. Regulations Recognize Captive Finance Companies are Not Financial Entities and Are Not Systemically Important

As noted in the Initial Comments, U.S. Congress and federal regulators have repeatedly recognized that captive finance companies are not financial entities for the purposes of clearing and do not pose systemic risk to world financial markets.

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act[10] ("Act") reflects this recognition by exempting the swap transactions of captive finance companies from the central clearing requirement applicable to other financial entities. The Act also excludes captive finance companies from the definition of "major swap participant" with respect to their swap hedging activities. Like the Second Consultative Document, the Act recognized a distinction between financial entities – who frequently engage in swaps for speculative purposes – and non-financial, commercial end-users (and their captive finance companies) – who enter into swaps to hedge commercial risks associated with their businesses.

The manner in which the U.S. Congress exempted captive finance companies from the mandatory clearing requirement was to exclude them from the definition of "financial entity" for purposes of clearing – i.e., by making the determination that captive finance companies should be regulated as commercial end-users rather than as financial entities. The Commodity Futures Trading Commission (CFTC), the primary regulator for U.S. swap activity, has reaffirmed this determination. In recent Congressional testimony, CFTC Chairman Gary Gensler said that the CFTC's margin proposal for uncleared swaps "provides that end-users will not have to post margin for uncleared swaps."[11] In the same testimony,

[9] See page 9 of the Second Consultative Document.
[10] U.S. Pub.L. 111-203, H.R. 4173
[11] Testimony of CFTC Chairman Gary Gensler Before the U.S. Senate Committee On Agriculture, Nutrition & Forestry, Washington, DC, (February 27, 2013), *See* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-132

Chairman Gensler stated unequivocally that "[The CFTC has] been advocating with global regulators for an approach consistent with that of the CFTC."[12]

Indeed, as we pointed out in our Initial Comments, the funding and hedging activities of a captive finance company are analogous to – and for the purposes of imposing a margin requirement should be considered as an extension of – the treasury division or department of a manufacturing company that is a non-financial, commercial end-user. From a policy perspective, it should not matter whether a non-financial, commercial end-user chooses to hedge its underlying commercial risks through an internally-organized treasury department or through a wholly-owned affiliate.

In order to be considered a captive finance company and to qualify for the exemption from the definition of a "financial entity" and subsequently, the mandatory clearing requirement, the Act contains a stringent test, referred to as the 90/90 test. The Act defines a captive finance company as:

> "[A]n entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."[13]

The legislative history of the Act clearly demonstrates that the U.S. Congress chose to treat captive finance companies as commercial end-users rather than financial entities because Congress knew that captive finance companies do not pose systemic financial risk. In the Initial Comments, we highlighted legislative history from the Act surrounding the creation of the Financial Stability Oversight Council ("FSOC")[14] – the federal agency responsible for designating entities as systemically risky – stating that captive finance companies do not pose systemic risk.[15] Specifically, we noted the following exchange between Chairman Barney Frank – a key architect of the Dodd-Frank Act – and Congresswoman Mary Jo Kilroy:

> *Representative KILROY. Thank you, Mr. Chairman. I would like to address the provisions of section 1103, which specifies the criteria to be considered in determining whether a financial company might be subject to stricter standards. <u>It is my understanding that nondepository captive finance companies do not pose the types of risks that warrant such treatment. . . . It is my understanding that it is the intent of the committee that nondepository captive finance companies are not the types of finance</u>*

[12] Id.
[13] See 7 U.S.C. 2(h)(7)(C)(iii) and 7 U.S.C. 1a(33)(D).
[14] FSOC was established by the Act and "is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system."
[15] See, Initial Comments, page 12.

> *<u>companies that should be subjected to stricter standards under section 1103 of this legislation; is that correct?</u>*
>
> *Chairman FRANK of Massachusetts. The gentlewoman is correct. . . . Financing companies are not depository institutions. They provide financing for the sale of that particular product in that company. <u>It is again inconceivable to me that somehow they would rise to the level of risk that would justify the Systemic Risk Council stepping in</u>.*[16]

Because captive finance companies meet both of the criteria articulated in Element 2(c) of the Second Consultative Document under national regulations, we believe initial and variation margin requirements do not apply to swap transactions entered into by captive finance companies. We therefore urge the Basel Committee and IOSCO to recognize that captive finance companies, which meet the 90/90 test and are not "financial entities" for the purpose of mandatory clearing, are "non-financial entities" that do not pose systemic risk for purposes of the Second Consultative Document.[17]

In the alternative, we ask the Basel Committee and IOSCO to clarify that the determination as to whether an entity is a "financial entity" under national regulation is based on whether that entity is treated as a "financial entity" or as a commercial end-user with respect to the mandatory clearing requirement. We believe that such a clarification will go a long way towards ensuring that potentially onerous margin requirements will not be applied to transactions to which they were not intended.

Although we believe that swap transactions entered into by captive finance companies fall outside of the framework articulated in the Second Consultative Document, we want to provide comments regarding another aspect of the Second Consultative Document.

<u>**Physically-Settled Foreign Exchange Forwards and Swaps Should be Exempt from Margin Requirements**</u>

The Second Consultative Document asks whether foreign exchange forwards and swaps should be exempted from initial and/or variation margin requirements. If variation margin is to be required, it asks whether it should be imposed based on supervisory guidance or national regulation. Finally, it inquires as to whether physically-settled forwards and swaps with different maturities should be subject to different treatments.

We believe that physically-settled foreign exchange forwards and swaps should be exempt from all margin requirements. The U.S. Treasury Department thoroughly examined the issue of foreign exchange forwards and swaps, and late last year, released a final

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[16] See, 155 Congressional Record (December 9, 2009), pg. H14431.

[17] Additionally, some manufacturing companies with captive finance operations in other jurisdictions, particularly those in Europe, structure those entities as regulated banks. However, given that the purpose and function of these entities remains the same as their captive finance company counterparts in other jurisdictions, it remains critical that these entities be exempt from mandatory clearing as well as margin. A contrary result would effectively nullify the clearing exemption and reduce the ability of non-financial, commercial end-users, like captive finance companies, to efficiently hedge their commercial risks.

determination ("Final Determination")[18] that excludes both foreign exchange swaps and foreign exchange forwards from the definition of a "swap" under the Commodity Exchange Act ("CEA").[19] The Final Determination thus had the effect of exempting physically-settled foreign exchange forwards and swaps from centralized clearing requirements and the margin requirements for uncleared swaps generally required under the CEA.[20]

The Final Determination notes that "foreign exchange swaps and forwards are particular types of transactions that are qualitatively different from other classes of derivatives"[21] for a variety of reasons:

- Foreign exchange swaps and forwards involve the actual exchange of the principal amounts of the two currencies in the contract. Their payment obligations are fixed at the inception of the agreement and involve the exchange of full principal for settlement, which greatly reduces the risk profile of these trades.
- Foreign exchange swaps and forwards typically have much shorter maturities than other derivatives,[22] also reducing the riskiness associated with such transactions.
- Foreign exchange swaps and forwards are not structured to evade regulatory requirements that apply to other types of swaps.
- Foreign exchange swaps and forwards already trade in a highly transparent and liquid market.
- The imposition of margin requirements on foreign exchange swaps and forwards would increase the costs of hedging activities, which could lead to a reduction in hedging activity and an overall increase in systemic risk – the exact opposite of what the Second Consultative Document seeks to achieve.

Having the Second Consultative Document conform with the U.S. Department of the Treasury's Final Determination will help ensure international harmonization of regulation – a key goal for all parties involved. If variation margin is to be required, it should be based on national regulation in order to maintain consistency with Element 2.6.

In addition, for all of the other reasons set forth above, the maturity of the instrument should have no impact on the treatment. Even those rare foreign exchange swaps and forwards with a longer maturity have a materially lower risk profile due to the exchange of principal, the transparency of the market, and the high level of liquidity.

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[18] See, U.S. Department of the Treasury, "Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act," Federal Register, Vol. 77, No. 224, Tuesday, November 20, 2012 at 69694.

[19] 7 U.S.C. §§1-25.

[20] Final Determination, fn. 8 ("Thus, as a result of this determination, pursuant to sections 1a(47)(E) and 1b of the CEA, foreign exchange swaps and forwards would not be subject to margin requirements under the CEA."

[21] Id., at 69696.

[22] Id. As noted in the Final Determination, "[I]nterest rate swaps and credit default swaps generally have maturity between two and thirty years, and five to ten years, respectively. In stark contrast, over 98 percent of foreign exchange swaps and forwards mature in less than one year, and 68 percent mature in less than one week."

Conclusion

Captive finance companies are a small, narrowly-defined group of companies that provide vital financing to support the sales and leasing activities of their parent manufacturers. In the United States, the U.S. Congress and regulators agree that captive finance companies are not financial entities required to centrally clear swap transactions into which they enter. Moreover, Congress has determined that captive finance companies do not pose systemic risk.

Under the Second Consultative Document, the determination as to whether a firm is non-financial and/or systemically important is based on appropriate national regulation. Therefore, we hope that the Basel Committee and IOSCO ensure broad harmonization of this framework to ensure it applies evenly across national regimes.

We further urge the Basel Committee and IOSCO to ensure that physically-settled foreign exchange forwards and swaps are exempt from margin requirements, thereby promoting international harmonization of regulations.

We thank you again for the opportunity to provide you with comments.

Sincerely,

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