

**Meeting between Federal Reserve Board and Other Agency Staff
and Representatives of the Mexican Government
October 26, 2012**

Participants: Christopher Paridon (Federal Reserve Board); Staff of the United States Department of the Treasury, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Commodity Futures Trading Commission

Mr. Ricardo Medina Alvarez, Mr. Luis Urrutia Corral, Mr. Jaime Cortina Morfin, and Mr. Pascual O’Dogherty (Banco de México); Mr. Carlos Serrano (Comisión Nacional Bancaria y de Valores); and Mr. Diego Borja Lascurain (Secretary of Finance and Public Credit)

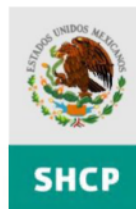
Summary: Staff of the Federal Reserve Board and other Federal agencies met with representatives of the Mexican Government to discuss the restrictions on proprietary trading and hedge fund and private equity fund activities under section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as the “Volcker Rule”).

Among matters discussed in the meeting were the Mexican Government’s views regarding: the potential cross-border effects of the Volcker Rule, including extra-territorial application of the Volcker Rule; the scope of the proposed rule’s application of the statutory exemptions for foreign activities of foreign banking entities; and potential application of the Volcker Rule to proprietary trading in obligations of the Mexican Government, including concerns over reduced market liquidity.

Representatives of the Mexican Government also shared their views on the enhanced prudential standards required under section 165 of the Dodd-Frank Act, as well as the so-called “swaps push-out” provisions of section 716 of that Act. A copy of the discussion document provided by the Mexican Government is attached.

Comments by Mexican Financial Authorities to the Dodd-Frank Wall Street Reform and Consumer Protection Act

October 2012



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Volcker Rule








Given the large presence of subsidiaries of US banks and other foreign banks (with U.S. operations) in Mexico, the Volcker Rule Proposal would apply to the Mexican banking system almost to the same extent as in the United States.

	Number of banks	Assets Billion USD	%
Mexican banks	24	123.7	27.6
Mexican subsidiaries of non-US banks	12	231.8	51.7
Mexican subsidiaries of US banks	6	92.5	20.7
TOTAL	42	447.9	100.0

Data as at July 2012
Source: SHCP and CNBV

Volcker Rule

Mexican 7 largest banks

Bank	Assets ^{1/}	Capital Adequacy Ratio ^{1/}	Tier 1 Capital ^{1/}
	Billion dollars	As a percentage of risk-weighted assets	
 BBVA Bancomer	94.6	16.0	11.5
 Citi Banamex	81.0	16.4	16.3
 Santander	58.5	15.0	14.7
 Banorte	45.9	14.8	11.8
 HSBC	36.7	14.4	11.1
 Inbursa	17.9	18.7	18.6
 Scotiabank	16.1	17.1	16.9

^{1/} Data as at August 2012

Source: Banxico y CNBV

Volcker Rule

Prohibitions and restrictions on the ability of banking entities and nonbank financial companies to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund

Section 619 of the Dodd Frank Act contains prohibitions and restrictions on the ability of banking entities and nonbank financial companies to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.

Under the proposal, U.S. insured depository institutions and their U.S. parent companies, foreign banks with a branch, agency or commercial lending company in the United States, parent companies of such foreign banks, and affiliates or subsidiaries of any of the aforementioned entities (covered banking entities) are subject to the Rule.

Covered banking entities are prohibited, with a few exemptions, from engaging, as principal for their own trading account, in any transaction to purchase or sell a wide range of covered financial positions.

Exempted activities: (i) Purchase or sale of the obligations of the US government or a US government agency, the government-sponsored enterprises, and state and local governments; (ii) trading outside the United States; (iii) market making; (iv) underwriting; (v) risk-mitigating hedging; (vi) trading on behalf of customers, and (vii) trading by a regulated insurance company. A transaction occurs solely outside the US only when four conditions are met: i) The transaction is conducted by a banking entity that is not organized under the laws of the United States or of one or more States; ii) no party to the transaction is a resident of the United States, iii) no personnel of the banking entity that is directly involved in the transaction is physically located in the United States; and iv) the transaction is executed wholly outside the United States.

Volcker Rule

The application of the Volcker Rule to Mexican financial institutions and to U.S. institutions that do business or invest in Mexico, or that have transactions with Mexican counterparties would have important negative effects on the Mexican financial system and on the financing costs of the Mexican government.

It would also restrict the ability of Mexican subsidiaries of U.S. banks to manage their risks and liquidity, lead to a fragmentation of the financial system and challenge the financial stability of United States' closest neighbor and partner without any benefit for the stability of the US financial system or the U.S. taxpayers.

Mexican financial authorities have particular concerns relating to the potential adverse effects of the proposed Volcker Rule on:

1. The ability of banks to manage their risks and liquidity,
2. The liquidity of the Mexican sovereign debt market,
3. The monetary policy operations of the central bank,
4. The liquidity of the Mexican peso foreign exchange market, and
5. The Mexican government's oil price hedging program.

Exceptions

The proposed Volcker Rule contemplates some exemptions for some activities: i) Purchase or sale of the obligations of the US government or a US government agency, the government-sponsored enterprises, and state and local governments; ii) trading outside the United States; iii) market making; iv) underwriting; v) risk-mitigating hedging; vi) trading on behalf of customers, and vii) trading by a regulated insurance company.

A transaction occurs solely outside the US only when four conditions are met: i) The transaction is conducted by a banking entity that is not organized under the laws of the United States or of one or more States; ii) no party to the transaction is a resident of the United States, iii) no personnel of the banking entity that is directly involved in the transaction is physically located in the United States; and iv) the transaction is executed wholly outside the United States.

Transactions solely outside of the United States

Suggestion:

- Make clear that the foreign subsidiaries of U.S. banks are non-residents of the U.S.
- Eliminate restrictions on non-U.S. trading related to the use U.S. financial infrastructure.

Otherwise, many banks would limit their activities involving U.S. counterparties and U.S. infrastructure to avoid potential non-compliance with the Volcker Rule. This would:

- Promote the fragmentation of financial markets.
- Harm the competitiveness of subsidiaries of U.S. banks.
- Hinder progress in implementing global initiatives like the use of trading platforms and CCP for OTC transactions.

Exceptions

Exceptions for market-making and risk management activities

These exceptions, as currently written, may impede a large portion of legitimate banks' activities.

- The exceptions and the proposed metrics could not be appropriate for banks to efficiently manage their balance sheet risks (ALM), particularly when they are not denominated in U.S. dollars.
- In emerging market economies, banks play a key role in preserving liquid and efficient financial markets by actively taking trading risk positions. Mexican banks' trading activities are essential for the liquidity of the Mexican sovereign debt market in which the large Mexican subsidiaries of U.S. banks have played a very important role in its development.

Suggestion: exclude Mexican government securities from the proprietary trading prohibition

*"Banks serve as a critical source of liquidity in [government securities markets]. In addition, these instruments have historically served a significant role in traditional banking activities, providing a low-risk, short-term liquidity position and are a commonly utilized source of collateral in transactions."*¹ The same reasoning applies to government securities in other jurisdictions.

An exception for trades in Mexican government securities will not affect the U.S. financial system nor the U.S. taxpayers. Mexican government securities are the safest and more liquid financial asset denominated in pesos. Moreover, the Mexican subsidiaries of U.S. banks operate in Mexico as independent legal entities with their own capital and liquidity and subject to the regulation and supervision of the Mexican authorities.

1 Financial Stability Oversight Council, "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds," study completed pursuant to section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, January 2011.

Volcker Rule

1. The ability of banks to manage their risks and liquidity

Mexican banks, including the subsidiaries of foreign banks have their balance sheets denominated predominately in pesos. They actively use Mexican government securities to manage their risks and liquidity.

- Excess deposits over credits as well as temporary differences between inflows and outflows are invested in government securities. Everyday, the central bank sterilizes any excess reserves held by a bank at the central bank (by selling government securities).
- Banks traditionally manage their balance sheet risks by actively trading securities (ALM).
- They also need to hold high credit quality liquid assets (HQLA) denominated in pesos for liquidity purposes. The best HQLA are Mexican government securities.

The inclusion of Mexican securities in the trading ban will hamper the ability of the Mexican subsidiaries of U.S. banks to efficiently manage their risks and liquidity and hurt their competitiveness.

Volcker Rule

2. The liquidity of Mexican sovereign debt market

In emerging market economies, banks' trading activities are essential to preserve the liquidity and efficiency of sovereign debt markets.

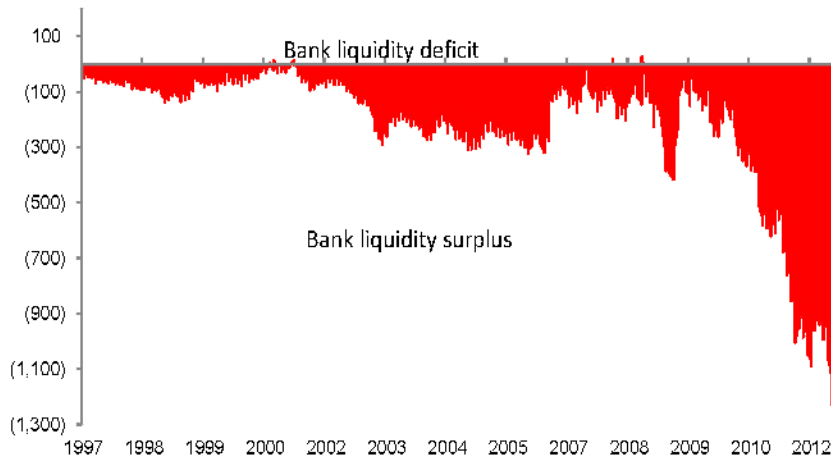
- The trading restrictions on Mexican securities would decrease the liquidity and raise the volatility of Mexican sovereign and corporate debt markets.
- They would also promote the fragmentation of financial markets as entities move away from U.S. counterparties.
- Diminished liquidity would limit the ability of banks, mutual funds and other institutional investors to efficiently manage their investments and risks.
- They would also increase funding costs for the government and for corporate issuers and trigger decreases in the value of existing financial instruments held by pension funds, institutions, and customers.
- They would also harm the competitiveness of the Mexican subsidiaries of U.S. banks.

Volcker Rule

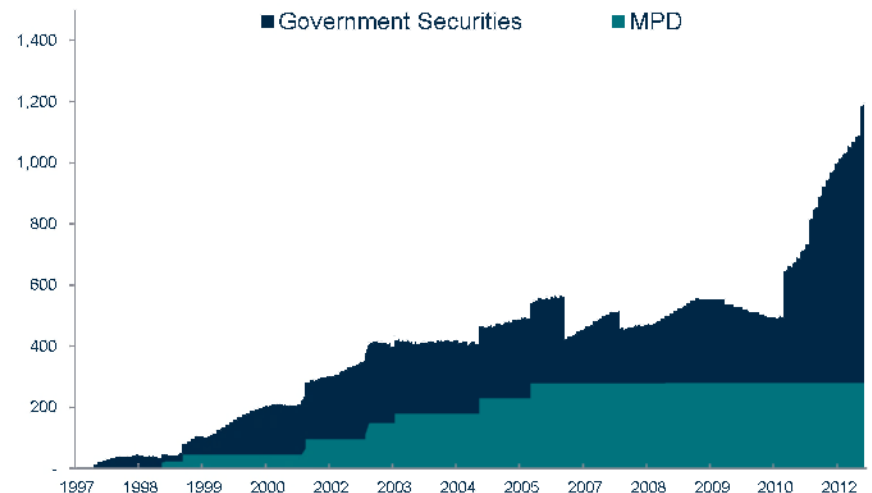
3. The open market operations of Banco de Mexico

The accumulation of international reserves by Banco de Mexico creates an enormous liquidity surplus in the banking system. The central bank monetary operations are designed to fully subtract all liquidity from the banks by selling medium and long-term government securities on a regular basis.

Net autonomous factors^{1/}
Billion pesos



Central bank liquidity operations – absorbing liquidity
Billion pesos



^{1/} Autonomous factors include: International Reserves (liquidity providing)
– Banks Notes in Circulation – Government Deposits (liquidity absorbing).

Volcker Rule

3. The open market operations of Banco de Mexico

Operations are conducted through the banking institutions, which act as intermediaries between the central bank and the market.

Banks usually hold these government securities for short periods of time in their balance sheets and then they sell them in the market.

Volcker Rule

4. The liquidity of the peso foreign exchange market

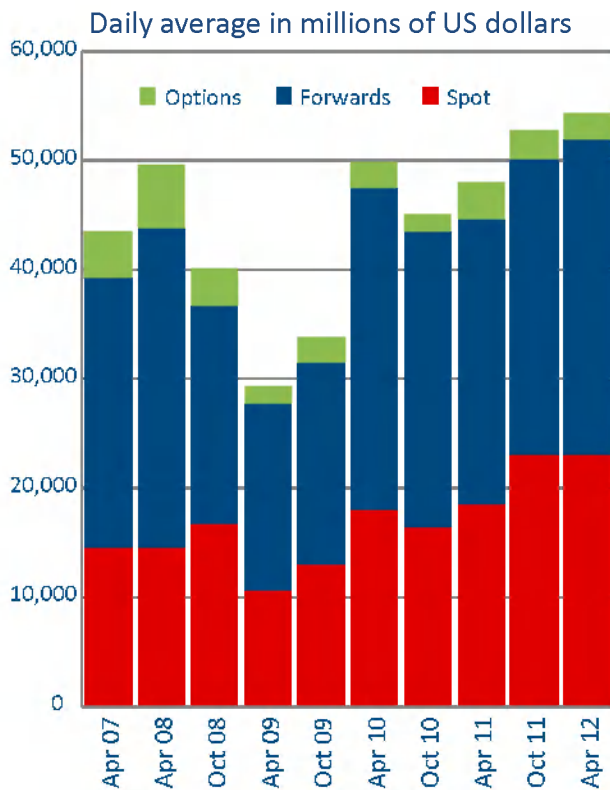
Restricting operation in FX forwards and Swaps could severely affect the liquidity of the peso FX market as an important proportion of the transactions does not take place on the Spot market.

Short-term FX exchange swaps are an important source of U.S. dollar funding for banks, particularly during periods of stress. The Mexican subsidiaries of U.S. banks—which are ineligible for the non-U.S. trading exemption— would be restricted in their ability to provide U.S. dollar funding to other banks through short-term swaps, raising funding costs and inducing banks to deleverage from dollar-denominated assets.

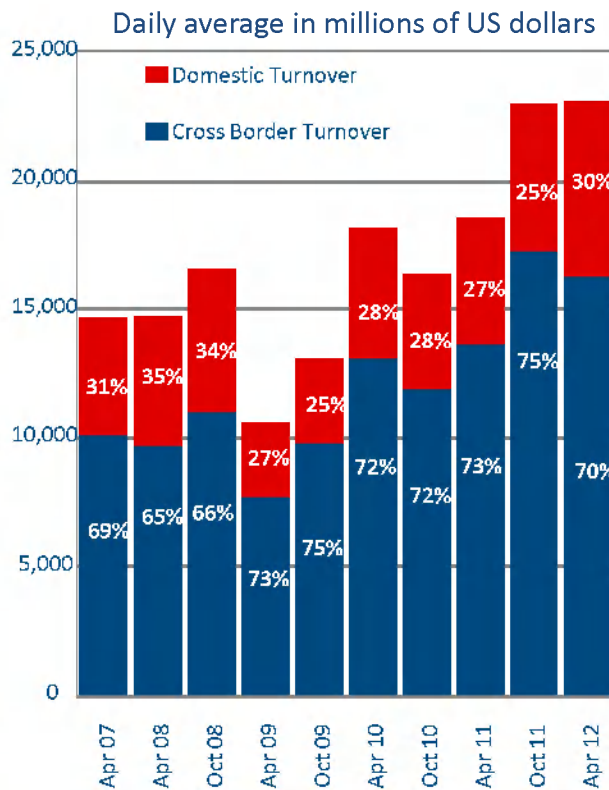
Volcker Rule

4. The liquidity of the peso foreign exchange market

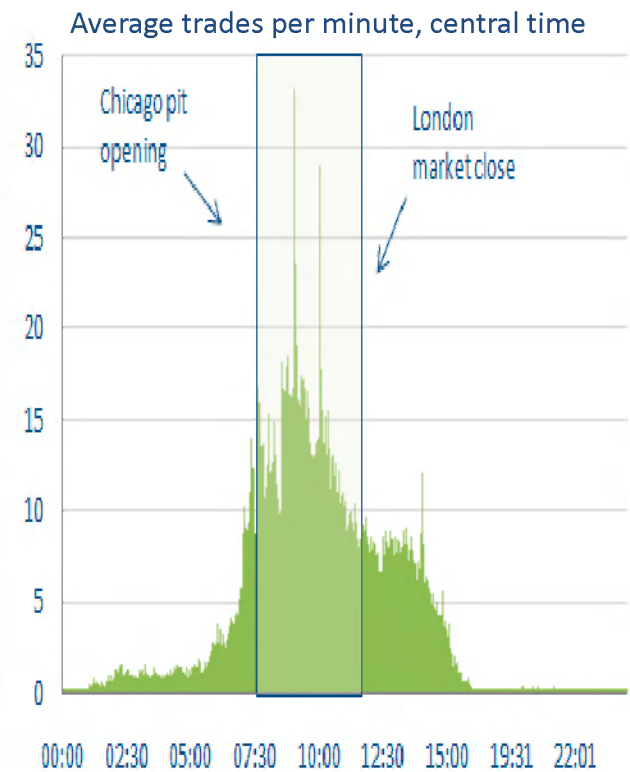
Mexican Peso Spot and OTC FX Derivatives Turnover



Mexican Peso Spot Trading Turnover



Trading Timeframe in the USDMEX Foreign Exchange Market in 2011



Source: BIS Triennial Central Bank Survey, Federal Reserve FXC Survey, Bank of England FXJSC Survey and Banco de Mexico.

Note: For April 2007 the data are from the Triennial BIS Survey. The others volumes are from Banco de Mexico, Federal Reserve (FXC Survey) and Bank of England (FXJSC Survey).

Source: Reuters

Volcker Rule

Suggestions:

- **Exclude operations in short-term FX swaps and forwards** from the proposed definition of covered financial positions.
- An exception for short-term FX swaps and forwards will not affect the U.S. financial system, nor the U.S. taxpayers.
- Mexican subsidiaries of U.S. banks operate in Mexico as independent legal entities with their own capital and liquidity and subject to the regulation and supervision of the Mexican authorities.

Volcker Rule

5. The Mexican government's oil price hedging program

The Volcker Proposal would significantly increase the costs of end users' activities in the commodities markets, including those with the sole purpose of hedging commercial activities.

A commodity hedge program of the size and characteristics of Mexico's oil price hedging program requires swap dealers to take significant commodity risks for extended periods of time in order to provide liquidity to markets.

Many elements of the proposed rule are vague and may be subject to a wide degree of interpretation. A misapplication of a metric-based approach may mistakenly categorize the risks taken by swap dealers as proprietary trading and result in forcing the swap dealer to cease the activity.

Changes in the hedging strategies by swap dealers will result in increased costs for end-users.

Regulation YY

- **Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies Subpart D—Single-Counterparty Credit Limits (Regulation YY)**

The Board of governors of the Federal Reserve System proposed rules that would implement the enhanced Prudential standards required to be established under section 165 of the Dodd-Frank Act and the early remediation requirements established under section 166 of the Act.

Given the definition of exposure to sovereigns and the characteristics of the highly liquid assets that covered companies will have to hold as proposed under the current draft regulation, the main concerns of Mexican authorities relate to:

1. The single-counterparty credit limits.
2. The liquidity requirements.

Regulation YY

1. The Single-Counterparty Credit Limit

The limit prohibits covered companies from maintaining a credit exposure to any unaffiliated company exceeding certain limits that range from 10 to 25 percent of their capital stock and surplus. The credit exposure is calculated by consolidating all credit exposures of its affiliates .

Large banks are very important investors in the sovereign of the countries where they are legally established. Sovereign exposures are usually the safest financial asset available.

- The proposal could limit the investment of Mexican subsidiaries of U.S. banks in the safest and more liquid asset available.
- The exposure for the parent bank arising from subsidiaries' holdings of sovereign debt is limited to its investment in the capital of the subsidiary.
- A failure of a sovereign to pay its obligations denominated in domestic currency very likely will have such a wide economic impact that exposure limits will not be of any use to protect local banks. A default of a bank's own sovereign is beyond the range of events against which an Large Exposures regime can be expected to offer protection.

Regulation YY

1. The Single-Counterparty Credit Limit

The proposal does not distinguish a credit risk exposure to a sovereign government from those to a central bank, a public enterprise, a state or a municipality.

Regulation YY

2. Liquidity requirements and the definition of highly liquid assets

Covered companies need to hold sufficient unencumbered highly liquid assets to cover 30-day stressed net cash outflows under their internal stressed scenarios. Institutions will be required to break down their analysis or monitoring by significant business line, legal entity, jurisdiction, and currency exposure. They are also required to maintain sufficient liquidity with respect to each significant legal entity in light of legal and regulatory restrictions on the transfer of the liquidity between them.

For this reason, it is likely that a subsidiary operating in Mexico will have to comply with the same requirement. The current wording of the proposal suggests that Mexican sovereign debt would not be classified as a highly liquid asset to comply with the requirement.

Regulation YY

Suggestions:

- Credit exposures to sovereigns of overseas subsidiaries should be excluded from the single counterparty credit limit, particularly when they are funded and denominated in the domestic currency of the U.S. subsidiary holding them.
- Single-counterparty credit limits should distinguish between domestic- and foreign-currency-denominated exposures, as well as between exposures to governments, central banks, and public agencies.
- Sovereign debt of the jurisdiction where a U.S. subsidiary is incorporated should be considered as a highly liquid asset when such debt is registered on the accounts of the subsidiary. This suggestion is in accordance with internationally agreed reforms such as Basel III in which global banks' foreign subsidiaries manage and maintain liquidity requirements using sovereign and central bank securities issued in the jurisdiction of incorporation.

Dodd-Frank: Title VII

- **Rules for transaction in derivative markets and products**

Title VII of the Dodd-Frank Act provides for the registration and comprehensive regulation of SDs and MSPs; imposes clearing and trade execution requirements on derivative products and creates rigorous recordkeeping and real-time reporting regimes.

Mexican authorities have concerns about the effects of the proposed Title VII regulation in three areas:

1. Registration requirements for subsidiaries of U.S. banks and Mexican banks,
2. Registration, clearing and disclosure requirements for foreign authorities, and
3. Registration of foreign Derivatives Clearing Organizations (DCOs) and Swap Data Repositories (SDR).

Dodd-Frank: Title VII

1. Registration requirements for overseas subsidiaries and Mexican banks

Most important instruments traded in Mexico are interest swaps and FX derivatives .

Regulatory requirements might discourage Mexican institutions from trading swaps with U.S. persons which might affect liquidity.

This practice will not only affect the depth and development of Mexican markets, it may also negatively affect the business model of Mexican affiliates and their risk management practices.

Dodd-Frank: Title VII

2. Registration, clearing and disclosure requirements for foreign authorities

Title VII exempts from swaps regulations any transaction to which the U.S. Federal Reserve is a party. However, foreign central banks do not receive a similar treatment which could conflict with central bank operations.

The final rule of the authorities contains an “End-User Exception to the Clearing Requirement for swaps” that will allow central banks to refrain from clearing requirements. The CFTC and SEC have determined not to provide categorical exclusions from the major participant definitions for foreign governments and various entities related to foreign governments (e.g., foreign central banks, international financial institutions, and sovereign wealth funds).

In addition, The Dodd-Frank Act authorizes the CFTC to make swap transaction and pricing data available to the public in such form and at such times as the Commission determines appropriate to enhance price discovery. However, disclosing such information, directly by being registered as SD/MSP or indirectly by transacting with SD/MSP, may affect central banks’ operations.

Dodd-Frank: Title VII

3. Registration of foreign Derivatives Clearing Organizations (DCOs) and Swap Data Repositories (SDR)

As we understand, a foreign DCO that clears, directly or indirectly, swaps traded by U.S. Persons should be registered with the CFTC or ask for an exemption of such registration. The CFTC registration procedure for DCOs is based on the compliance of the CFTC core principles.

Under Mexican regulation, the Mexican Peso Interest Rate Swaps (MXP-IRS) will be declared as standardized and required to be cleared through CCPs.

Currently, there is no CCP that clears OTC MXP-IRS contracts. The local derivatives CCP, Asigna, is working on the necessary adjustments in order to clear such contracts.

U.S. Persons are involved in the majority of such transactions.

Therefore for the Mexican derivatives market it is critical that Asigna could clear transactions in which U.S. Persons are involved and that they could benefit from lower capital charges applied to centrally cleared derivatives.

Dodd-Frank: Title VII

3. Registration of foreign Derivatives Clearing Organizations (DCOs) and Swap Data Repositories (SDR)

As established in the Guidance, all swap transactions with U.S. Persons shall be registered in an SDR. The CFTC will permit compliance in foreign Trading Repositories (TRs), provided that CFTC has direct access to the swap data stored in it.

A foreign authority having access to data directly from our TR is not allowed by the Mexican laws that regulate financial secrecy.

However Mexican supervisors are entitled to share such information with foreign authorities through MOUs in which reciprocity is considered.

Dodd-Frank: Title VII

Suggestions:

- Foreign governments and central banks should not have the obligation to be registered under Title VII of Dodd-Frank.
- U.S. authorities should clarify their approach to “substituted compliance,” take a comprehensive view of overseas’ regulatory regimes (ie, the outcome of regulation as opposed to a rule by rule basis) and incorporate the internationally agreed principles when evaluating frameworks for substituted compliance.
- In order to foster international cooperation and harmonization we believe that the recognition of foreign DCOs and SDRs shall rely on the basis of the local regulator adopting rules and regulations consistent with international standards, where peer reviews from different international bodies can be taken into account. This approach for DCOs is consistent with the one established in the BCBS “Report on Capital Requirements for Bank Exposures to Central Counterparties”, particularly with the definition of “qualifying CCP”.
- Additionally, for SDRs we suggest the US authorities consider access to swap data stored in the Mexican TR through Mexican financial authorities.