BANCO DE MÉXICO

February 13, 2012

By Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20551

Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20520

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Joint Notice of Proposed Rulemaking Implementing Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The Banco de México appreciates the opportunity to comment on the joint notice of proposed rulemaking[1] implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as the "Volcker Rule" (the "Volcker Proposal"). We are concerned with the potential effects of the Volcker Proposal on Mexican financial entities and markets through its application to financial institutions that do business or invest in Mexico, or that have transactions with Mexican counterparties, including the Mexican government. We have specific concerns relating to the potential adverse effects of the Volcker Proposal on the liquidity of Mexican sovereign and municipal debt markets and on the Mexican peso foreign exchange market.

We fully support efforts by the United States and other countries and international bodies to strengthen prudential regulation of the global banking system. Mexico is an active participant in such efforts through the G-20, the Financial Stability Board, the Bank for

[1] 76 Fed. Reg. 68,846 (Nov. 7, 2011); 77 Fed. Reg. ______ (Feb. __, 2012).

International Settlements, and the Basel Committee on Banking Supervision. We remain committed to internationally coordinated reforms to strengthen the global financial system and address issues of systemic risk through improved cooperation in areas such as heightened capital standards and recovery and resolution planning. We also support individual countries' efforts to implement additional reforms designed to strengthen their domestic banking systems. It is important, however, that these additional reforms are not applied in a manner that leads to unjustified and inappropriate extraterritorial effects.

We are concerned that the Volcker Proposal could impose significant restrictions on the trading activities of financial institutions that have operations in Mexico, trade on Mexican markets with Mexican counterparties, or invest in Mexican assets. Mexican financial markets could suffer significant losses in liquidity if these activities are restricted. In particular, if the Proposal restricts the Mexican securities trading activities of Mexican and international banks, it could decrease liquidity for Mexican sovereign, municipal and corporate debt, which would increase volatility and financing costs for the Mexican public and private sectors and harm the Mexican economy. The Proposal could also hinder the ability of banks to manage their risks and could interfere with the liquidity and efficiency of foreign exchange markets by restricting positions in swaps and forwards. Finally, the Volcker Proposal could also affect Banco de México's capacity to implement monetary policy through open market operations.

We urge the U.S. regulatory authorities to revisit their proposed approach to implementing the Volcker Rule and consider how to avoid unwarranted adverse effects in the economies of Mexico and other countries. Among other things, we encourage the U.S. regulatory authorities to exempt trading in debt securities issued by the Mexican federal government, states, municipalities and public agencies to the same extent that the Volcker Rule exempts trading in U.S. government, state, agency and municipal debt.

The Mexican and U.S. Financial Systems are Highly Interconnected

Given its application to both U.S. banks and international banks with U.S. operations, the Volcker Proposal would apply to the Mexican banking system almost to the same extent as in the United States. One of the largest banks in Mexico is a subsidiary of a U.S. bank, and most of the major banks operating in Mexico are subsidiaries of either U.S. banking institutions or international banks with U.S. operations. Indeed, the five largest Mexican banks would be subject to the Volcker Proposal.[2] Furthermore, all eight of the currently approved "Formadores de Mercado," or primary dealers, of locally issued Mexican government debt are subsidiaries of international banks that would be subject to the Volcker Proposal; three of those eight are owned by U.S.-headquartered banking organizations. The financial services these institutions provide in Mexico, and to Mexican counterparties, would therefore apparently be subject to the restrictions in the Volcker Proposal.

[2] Four of the five largest Mexican banks are owned by banks headquartered outside of Mexico which also have U.S. branches, agencies or subsidiaries. The only domestically owned Mexican bank of those five has a U.S. bank subsidiary, and therefore would also be subject to the Volcker Proposal.

As in many other countries, Mexican banks and other financial market participants also rely on U.S. financial exchanges, execution facilities, clearing and settlement systems, and other U.S.-owned financial infrastructure. The Mexican government relies on the U.S. capital markets and U.S. financial infrastructure to issue dollar-denominated debt, most of which is underwritten by banks subject to the Volcker Proposal and sold predominantly to U.S. and other international investors.[3]

If the U.S. regulators implement the Volcker Rule in a manner that places restrictions on non-U.S. trading that relies on U.S. financial infrastructure or involves a U.S. counterparty, or that otherwise applies to international banks operating outside the United States, it is likely to have a significant impact on the Mexican financial system and the finances of the Mexican government. We are concerned that the breadth of this proposed implementation could challenge the financial stability of the United States' closest neighbors and partners.

Concerns Regarding the Volcker Rule's Potential Effects on the Mexican Banking System, Liquidity in the Mexican Government Securities Markets, and Public-Sector Financing Costs

As we understand the Volcker Proposal, it would generally prohibit banking entities, including international banks and their subsidiaries and affiliates, from engaging in proprietary trading, subject to certain key exemptions. Although the statute contains exemptions intended to limit the Volcker Rule's extraterritorial application and to preserve beneficial customer-oriented activities, we are concerned that the proposed manner in which these exemptions would be implemented could have unnecessary negative effects. In particular, the absence of an exemption for Mexican and other non-U.S. government securities (and derivatives referencing these securities) from the Volcker Proposal would impose particular burdens on international banks that rely on peso-payable debt securities[4] to manage the liquidity and funding risks arising from their Mexican operations, and would be likely to have significant negative effects on the liquidity of the Mexican sovereign debt markets. Banks' local currency deposits are placed mostly in local currency loans and securities, especially local government securities. These non-U.S. sovereign securities, including Mexican government bonds, would not be exempt instruments.

The main provision in the Volcker Proposal intended to implement the statutory exemption for the non-U.S. activities of international banks may not accomplish this purpose as proposed. One of the largest banks in Mexico would not be eligible for this exemption because it is affiliated with a U.S. bank. Neither would three of the eight current primary dealers in

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3 For example, the Mexican government has issued over US$37 billion in debt in 29 separate issuances over the last ten years under Mexico's U.S. shelf registration and its global medium-term note program. All but six of these were denominated in U.S. dollars, approximately 70% of the principal amount of that debt was sold in the United States, and the lead underwriters for all of these deals will be subject to the Volcker Rule once it becomes effective (except for one institution which is no longer in business). Although these deals do not reflect all of Mexico's debt issuances over that period, they demonstrate the prominent role that U.S. markets, infrastructure, and institutions play in Mexican public finance.

4 "Peso-payable" debt securities include debt securities denominated in pesos and inflation-indexed securities denominated in *unidades de inversión* and payable in pesos.

Mexican government debt. For other international banks, all trading with U.S. counterparties or on U.S. exchanges or execution facilities would be subject to the Volcker Proposal. The proposed approach would also restrict any trading in which a U.S. employee of an international bank played a direct role, regardless of whether the activity presented any risk to U.S. taxpayers or U.S. financial stability. Given Mexico's proximity to the United States and the ubiquity of U.S. financial infrastructure, we have serious doubts that the international banks operating in Mexico will be able to effectively separate their U.S. and non-U.S. trading activities.

To the extent a bank operating in Mexico would be subject to the Volcker Proposal and unable to rely on the non-U.S. trading exemption, the Proposal would impose significant compliance, reporting, and recordkeeping obligations on such a bank's Mexican operations in order to detect and prevent proprietary trading. It would be inconsistent with long-standing principles of international comity and traditional approaches to cross-border banking supervision and regulation for the United States to impose U.S. prudential requirements and examination and monitoring obligations on the operations of banks in Mexico. Application of these restrictions to international banks operating in Mexico would likely lead to reduced liquidity in Mexican sovereign debt markets and higher financing costs for the Mexican government.

We are concerned that the market making, underwriting, hedging and non-U.S. trading exemptions may be insufficient to avoid a significant negative effect in the Mexican sovereign debt markets and the Mexican banking system. For example:

- Primary dealers in Mexican peso-payable sovereign debt are obligated to bid on each issuance, without regard for expected customer demand. In order to keep the primary dealer business financially attractive, it is important for these dealers to be permitted to profit from the resulting proprietary positions, including by holding significant positions in anticipation of future price movements, and to hedge such transactions through derivatives referencing Mexican debt. The Volcker Proposal does not recognize that in many markets, including Mexico, dealers should take principal positions in order to maintain efficient and liquid markets. Liquidity and financing costs for Mexican sovereign debt improved significantly after Mexico implemented a primary dealer system in October 2000. The market making, underwriting and hedging exemptions in the Volcker Proposal are too narrowly drafted to permit these activities to continue unaffected.

- A substantial portion of Mexican sovereign debt—both peso- and dollar-denominated—is sold to U.S. and other international investors, either directly by our underwriters or, in the case of peso-payable debt, through Mexican market makers participating in our domestic auctions. As currently drafted, the non-U.S. trading exemption would appear not to exempt these sales. It would be very difficult for the primary dealers, market makers and underwriters of our debt securities to segregate their U.S.- and non-U.S.-facing sales. As mentioned above, three of the eight currently designated primary dealers are owned by U.S.-headquartered institutions, and therefore would be unable to rely on the non-U.S. trading exemption.

Under the Volcker Proposal, banks' ability to trade in Mexican sovereign debt as primary dealers and in the secondary market could be significantly restricted, especially in the United States, which could reduce liquidity and increase financing costs in Mexico, affecting also Banco de Mexico's capacity to implement monetary policy. We believe these effects could have real and significant negative consequences for the Mexican economy.

The Importance of Exempting Mexican Sovereign Debt from the Volcker Rule's Restrictions on Trading

Consistent with the law as adopted by the U.S. Congress, the Volcker Proposal would exempt trading in U.S. government, state, municipal and agency securities from the prohibitions on proprietary trading. As a result, international banks trading in U.S. government securities would not need to comply with the conditions and compliance program requirements associated with the underwriting, market making and hedging exemptions when buying and selling U.S. government securities. We understand the compelling U.S. policy rationale behind permitting banking organizations to trade U.S. government securities freely.

We would respectfully submit that the policy justifications for including an exemption for trading in U.S. government securities strongly support a similar exemption for trading Mexican government, state, municipal and agency debt. Consequently, we would strongly urge the U.S. regulatory authorities to adopt a parallel exemption for trading Mexican and other sovereign debt, and on derivatives referencing such securities. Such an exemption would avoid the concerns we have outlined above regarding potentially damaging effects on the liquidity of other sovereign debt markets—and the safety and soundness of financial institutions operating in those jurisdictions—and would be consistent with promoting the safety and soundness of U.S. banks and U.S. financial stability.

Indeed, in our view, the United States' national treatment undertakings in the North American Free Trade Agreement ("NAFTA") would require the inclusion of such an exemption in order to give comparable treatment to Mexican government debt as compared to U.S. government debt. The required assurance of equal competitive opportunities by a NAFTA party must not "disadvantage financial institutions and cross border financial services providers of another Party in their ability to provide financial services as compared with the ability of the Party's own financial institutions and financial services providers to provide such services, in like circumstances." We do not believe this standard is satisfied by permitting banks to trade freely in U.S. government debt, while requiring banks that trade in Mexican government debt to comply with extensive restrictions and compliance, reporting and recordkeeping obligations. Although there is an exception in NAFTA that permits a Party to adopt reasonable prudential measures for safety and soundness reasons and for the maintenance of the integrity of and stability of a Party's financial system, we do not believe that the exclusion of Mexican government debt from like treatment with U.S. government debt can be justified under this exception. We do not believe that the U.S. Congress or the regulators charged with implementing the Volcker Rule have developed a record to support a conclusion that financial institutions trading in Mexican government debt could represent a threat to the safety and soundness or integrity of the U.S. financial system. To the contrary, placing constraints on trading Mexican government debt could present risks to Mexico's financial system and would be inconsistent with promoting the safety and soundness of financial institutions operating in Mexico (including U.S. banks).

In our view, the implementing approach proposed in the Volcker Proposal could lead to decreased liquidity in Mexican sovereign debt markets. We would respectfully urge the U.S. regulatory authorities to revise their proposed approach to implementation of the Volcker Rule in a manner that operates in harmony with the global financial regulatory system and principles of comity and that avoids undue and unnecessary extraterritorial effects.

Applying the Volcker Rule to Foreign Exchange Swaps and Futures Could Harm the Ability of Mexican Banks to Manage their Risks Effectively

The Volcker Proposal would apply to foreign exchange swaps and futures. Short-term foreign exchange swaps are an important source of U.S. dollar funding for banks, particularly during periods of stress. Under the Volcker Proposal, U.S. banks and 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. We urge the Agencies to exclude foreign exchange swaps and futures from the Volcker Proposal.

Application of the Volcker Rule to the Mexican Operations of U.S. and International Banks Could Harm Liquidity in Mexican Financial Markets

We also urge the U.S. regulators to more broadly exempt the Mexican operations and trading activities of both international banks and the Mexican subsidiaries of U.S. banks from the restrictions and compliance requirements of the Volcker Proposal. The substantive restrictions and significant compliance, reporting, and recordkeeping obligations the Volcker Proposal will place on such banks' Mexican operations would be likely to reduce liquidity in Mexican financial markets more broadly, and could significantly raise the cost of financial services in Mexico. It will also undermine the soundness of foreign subsidiaries of U.S. banks as it would significantly hamper their ability to compete with non-U.S. banks in their foreign jurisdictions of incorporation. As explained above, we believe application of the Volcker Proposal in these circumstances would be inconsistent with principles of international comity and traditional approaches to cross-border banking supervision and regulation. To the extent an international bank or a U.S. bank's Mexican subsidiary is operating in Mexico, these principles indicate that the United States should defer to Mexican regulation or apply a less restrictive alternative than the existing proposal.

Credit and Infrastructure Funds Organized or Sponsored by U.S. and International Banks are a Major Source of Capital for Mexican Infrastructure and Economic Development

We understand that the Volcker Rule was intended to limit relationships between U.S. banks and hedge and private equity funds. However, the Volcker Proposal would apply to a wide variety of funds and other corporate structures, including many funds that do not resemble hedge funds and private equity funds, and many funds that are not organized or offered in the United States. We are concerned that these restrictions could restrict the flow of credit and capital from credit and infrastructure funds to the Mexican economy. Such funds do not resemble traditional hedge funds or private equity funds, and we urge the U.S. regulators to preserve this important flow of investment capital into the Mexican economy.

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We appreciate your consideration of our concerns regarding the Volcker Proposal. We look forward to continuing to work together to build the financial and economic partnership between Mexico and the United States, and we would be more than happy to discuss these matters with you further.

Very truly yours,

Agustín Guillermo Carstens Carstens
Governor