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MEMORANDUM TO: Board of Directors

FROM:

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SUBJECT: Notice of Proposed Rulemaking; Recordkeeping Requirements for Qualified Financial Contracts

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Proposal: That the Board of Directors of the Federal Deposit Insurance Corporation approve for publication in the Federal Register the attached Notice of Proposed Rulemaking, Recordkeeping Requirements for Qualified Financial Contracts (NPR) for a 60-day public comment period. The proposed rule would establish recordkeeping requirements for qualified financial contracts (QFCs) held by insured depository institutions in a troubled condition, as defined in the proposed rule. The proposed rule and appendix would require an institution in a troubled condition, upon written notification by the institution's appropriate Federal banking agency or the FDIC, to produce immediately at the close of processing of the institution's business day, for a period provided in that notification, (1) electronic files for certain position level and counterparty level data; (2) electronic or written lists of (i) QFC counterparty and portfolio identifiers, (ii) certain affiliates of the institution and the institution's counterparties to QFC transactions, (iii) contact information and organizational charts for key personnel involved in QFC activities, and (iv) contact information for vendors for such activities; and (3) copies of key agreements and related documents for each QFC.

Recommendation: That the Board approve the publication of this Notice of Proposed Rulemaking for a 60-day public comment period.

Supplemental Information:

I. <u>FDIC as Receiver's Statutory Obligations with Respect to QFCs</u>

QFCs are certain financial contracts that have been defined in the Federal Deposit Insurance Act (FDI Act) and that receive special treatment by the FDIC in the event of the failure of an insured depository institution (institution). The special treatment of QFCs after the FDIC's appointment as receiver or conservator for a failed institution initially was codified in FDI Act as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and places certain restrictions on the FDIC as receiver for a failed institution that held QFCs.

The FDI Act identifies QFCs using the statutory definition of five specific financial contracts. This statutory list of QFCs consists of securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements. The FDIC also may define other similar agreements as QFCs by rule or order.[1] In addition, a master agreement that governs any contracts in these five categories is treated as a QFC as are security agreements that ensure the performance of a contract from the five enumerated categories.

Under the FDI Act and other U.S. insolvency statutes, a party to QFCs with the insolvent entity can exercise its contractual right to terminate QFCs and offset or net out

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[1] The FDIC has provided clarifying definitions for repurchase agreements and swap agreements in 12 C.F.R. § 360.5.

any amounts due between the parties and apply any pledged collateral for payment. Under the Bankruptcy Code, this right is immediate upon initiation of bankruptcy proceedings, while under the FDI Act, counterparties cannot exercise this contractual right until after 5:00 p.m. (Eastern Time) on the business day following the appointment of the FDIC as receiver. By contrast, parties to most contracts with insured institutions cannot terminate the contracts based upon the appointment of the FDIC as receiver. The special rights granted by the FDI Act to QFC counterparties are designed to protect the stability of the financial system and to reduce the potential for cascading interrelated defaults.

If QFC counterparties were unable to terminate and liquidate their positions in a timely manner after the failure of an institution, they would be exposed to market risks and uncertainty regarding the ultimate resolution of QFCs. Absent the ability to terminate a QFC in a timely manner when the counterparty becomes insolvent (which may include exercising rights to offset positions, net payments, and the use of collateral to cover amounts due), the potential for fluctuation in the value of the QFCs from changes in interest rates and other market factors may create market uncertainty that could lead to broader market disruptions.

After its appointment as receiver, the FDIC has three options in managing the institution's QFC portfolio: (1) transfer the QFCs to another financial institution, (2) repudiate the QFCs, or (3) retain the QFCs in the receivership. Within certain constraints, the FDIC can apply different options to QFCs with different counterparties.

First, the receiver may transfer a QFC to any other financial institution not currently in default, including but not limited to foreign banks, uninsured banks, and bridge banks or conservatorships operated by the FDIC. If the receiver transfers a QFC to another financial institution, the counterparty cannot exercise its contractual right to terminate the QFC based solely on the transfer, the insolvency, or the appointment of the receiver.

Second, the FDIC as receiver may repudiate a QFC, within a reasonable period of time, if the receiver determines that the contract is burdensome. If the receiver repudiates the QFC, it must pay actual direct compensatory damages, which may include the normal and reasonable costs of cover or other reasonable measure of damages used in the industry for such claims, calculated as of the date of repudiation. If the receiver determines to transfer or repudiate a QFC, all other QFCs entered into between the failed institution and that counterparty, as well as those QFCs entered into with any of that counterparty's affiliates, must be transferred to the same financial institution or repudiated at the same time.

Third, the FDIC as receiver may retain a QFC in the receivership. This option would allow the counterparty to terminate the contract. If a QFC is terminated by the counterparty or repudiated by the receiver, the counterparty may exercise any contractual right to net any payment the counterparty owes to the receiver on a QFC against any payment owed by the receiver to the counterparty on a different QFC.

The FDIC as receiver has very little time to choose among these three options. Under the FDI Act, the FDIC as receiver has until 5:00 p.m. (Eastern Time) on the business day following the date of its appointment as receiver to make its decision to transfer any QFCs. During this period, counterparties are prohibited from terminating or otherwise exercising any contractual rights triggered by the appointment of the receiver under the QFC agreements. In effect, the same time limitation applies to repudiation because, after the expiration of this brief stay, counterparties are free to exercise any contractual right to terminate the QFCs and avoid the FDIC's power to repudiate. If the FDIC as receiver decides to transfer any QFCs, it must take steps reasonably calculated to provide notice of the transfer of the QFCs at the failed institution to the relevant counterparties, who are prohibited from exercising such rights thereafter.

To make a well-informed decision on these three options, the FDIC needs access to information such as the types of QFCs, the counterparties and their affiliates, the notional amount and net position on the contracts, the purpose of the contracts, the maturity dates, and the collateral pledged for the contracts. Given the FDI Act's short time frame for such decision by the FDIC, in the case of a QFC portfolio of any significant size or complexity, it may be difficult to obtain and process the large amount of information necessary for an informed decision by the FDIC as receiver unless that information is readily available to the FDIC in a format that permits the FDIC to quickly and efficiently carry out an appropriate financial and legal analysis.

In light of the large volume of information concerning QFCs that a receiver must process in the limited time frame set forth in the FDI Act, the FDIC is proposing QFC recordkeeping requirements for institutions in a troubled condition, as described below. The absence of adequate information for decision-making by the FDIC as receiver increases the likelihood that, in a failed bank situation, QFCs will be left in the receivership or repudiated, instead of transferred to open institutions or a bridge bank. The FDIC does not believe that the proposed QFC recordkeeping requirements are overly burdensome, but encompass information that should be maintained by institutions as part of their risk management of capital market activities. Given the business and related counterparty risks and supervisory considerations, the FDIC believes that the proposed recordkeeping requirements are consistent with safe and sound banking practices by institutions holding QFCs.

II. The Proposed Rule

In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act was enacted, with section 908 of the Act authorizing the FDIC, in consultation with the other Federal banking agencies, to set recordkeeping requirements for QFCs held in institutions determined to be in a "troubled condition." Consistent with this statutory authority, the proposed rule applies to all institutions that are FDIC-insured and deemed to be in a troubled condition.

For purposes of this proposed rule, "troubled condition" means any insured depository institution that (1) has a composite supervisory rating, as determined by its appropriate Federal banking agency in its most recent examination, of 3 (only if the insured depository institution has total consolidated assets of ten billion dollars or greater), 4 or 5 under the Uniform Financial Institution Rating System, or in the case of an insured branch of a foreign bank, an equivalent rating; (2) is subject to a proceeding initiated by the FDIC for termination or suspension of deposit insurance; (3) is subject to a cease-and-desist order or written agreement issued by the appropriate Federal banking agency, as defined in 12 U.S.C. 1813(q), that requires action to improve the financial condition of the insured depository institution or is subject to a proceeding initiated by the appropriate Federal banking agency which contemplates the issuance of an order that requires action to improve the financial condition of the insured depository institution, unless otherwise informed in writing by the appropriate Federal banking agency; (4) is informed in writing by the insured depository institution's appropriate Federal banking agency that it is in troubled condition for purposes of 12 U.S.C. 1831i on the basis of the institution's most recent report of condition or report of examination, or other information available to the institution's appropriate Federal banking agency; or (5) is determined by the appropriate Federal banking agency or the FDIC in consultation with the appropriate Federal banking agency to be experiencing a significant deterioration of capital or significant funding difficulties or liquidity stress, notwithstanding the composite rating of the institution by its appropriate Federal banking agency in its most recent report of examination.

The third and fourth criteria of the term "troubled condition" as defined in this proposed rule are similar to criteria for the definition of that term in other FDIC rules and the rules of the other Federal banking agencies (which generally implement 12 U.S.C. 1831i, regarding the Federal banking agencies' approval of appointment of directors and senior executive officers of institutions).[2] However, the first, second, and fifth criteria for the definition of "troubled condition" in the proposed rule differ from the other agencies' rules that implement 12 U.S.C. 1831i.

Consistent with the FDIC's and the other Federal banking agencies' definition of "troubled condition" for purposes of 12 U.S.C. 1831i, the first criterion of the definition of "troubled condition" in this proposed rule includes institutions with a composite rating, as determined by its appropriate Federal banking agency in its most recent examination, of 4 or 5 under the Uniform Financial Institution Rating System, or in the case of an

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[2] See 12 CFR 303.101(c) (FDIC), 12 CFR. 5.51(c)(6) (OCC), 12 CFR 225.71(d) (FRB); and 12 CFR 563.555 (OTS).

insured branch of a foreign bank, an equivalent rating. However, for purposes of this first criterion for "troubled condition" in this proposed rule, the FDIC has included any insured depository institution with total consolidated assets of ten billion dollars or greater and a composite rating, as determined by its appropriate Federal banking agency in its most recent examination, of 3 under the Uniform Financial Institution Rating System. The inclusion of institutions of such asset size with a composite rating of 3 reflects the risks to the deposit insurance fund arising from large institutions with QFC portfolios for which the appropriate Federal banking agency has assigned a composite rating of 3.

The second criterion of the definition of "troubled condition" in this proposed rule reflects the FDIC's responsibility to terminate the deposit insurance of institutions that pose unreasonable risk to the deposit insurance fund. Similarly, the fifth criterion of this definition is based on circumstances that create a significant risk that an institution may require the appointment of the FDIC as receiver.

In accordance with section 11(e)(8)(H) of the FDI Act, we have consulted with the other Federal banking agencies regarding the proposed part 370 and Appendix A. This NPR reflects various comments from the other Federal banking agencies.

III. <u>Appendix A: QFC Recordkeeping Requirements</u>

Appendix A to proposed Part 370 sets forth the specific QFC recordkeeping requirements proposed in this NPR. These QFC recordkeeping requirements are organized under three categories as provided in Appendix A: (1) position level data (Table A1), (2) counterparty level data (Table A2), and (3) certain contracts and lists of counterparty affiliates and identifiers, affiliates of the institution that are counterparties to

QFC transactions, organizational charts involving the institution and its affiliates, and supporting vendors (Section B). An institution in a troubled condition would be required to maintain the position level data and counterparty data listed under Tables A1 and A2 in electronic files in a format acceptable to the FDIC, and such institutions would be required to demonstrate the ability to produce this information immediately at the close of processing of the institution's business day, for a period provided in a written notification by the FDIC. The files required under Section B are less quantitative and could be maintained in electronic formats, in written formats, or in a combination of those two formats. Nonetheless, the nature of this information would require that it be updated and available upon request on a daily basis.

The proposed rule and Appendix A are intended to facilitate the ability of the receiver to gather relevant information on QFCs in order to make business decisions within the short time frame between when a failure occurs and when the FDIC as receiver must act under 12 U.S.C. 1821(e)(9) and (10). Also, the data fields and related information required in Appendix A are important for the due diligence by institutions of their QFC agreements in conjunction with their risk management policies and procedures.

Table A1. Table A1 would require data that must be maintained regarding QFC positions entered into by that institution. For such data, the institution would demonstrate the ability to produce immediately at the close of processing of the institution's business day, for a period provided in a written notification by the FDIC, a report that aggregates the current market value and the amount of QFCs by each of the delineated fields. In addition, the FDIC also may require a certain combination of recordkeeping fields from

Table A1 where significant for purposes of its evaluation of risks associated with the institution's positions.

The following data fields are required in Table A1: (1) unique position identifier (including CUSIP identifiers or unique trade confirmation numbers, if available); (2) portfolio location identifier; (3) type of position; (4) purpose of the position; (5) termination date; (6) next call, put, or cancellation date; (7) next payment date; (8) current market value of the position; (9) unique counterparty identifier; (10) notional or principal amount of the position; and (11) documentation status of the position.

Table A2. Table A2 requires data that must be maintained at the counterparty level for all QFCs entered into by an institution. For such data, the institution must demonstrate the ability to produce immediately at the close of processing of the institution's business day, a report that (i) itemizes, by each counterparty and its affiliates with QFCs with the institution, the data required in each field delineated in Table A2; and (ii) aggregates by field, for each counterparty and its affiliates, the data required in each field.

The following data fields are required in Table A2: (1) unique counterparty identifier, (2) current market value of all positions, (3) current market value of all collateral posted by the institution, (4) current market value of all collateral posted by counterparties, (5) institution's collateral excess or deficiency, (6) counterparty's collateral excess or deficiency, and (7) institution's collateral excess or deficiency for all positions.

Data files and contract information required under Section B: Section B of Appendix A requires that other data files be maintained in either written or electronic format for QFCs and upon a written request by the FDIC, be produced immediately at the close of processing of the institution's business day, for a period provided in that written request. Each institution must maintain lists of: counterparty identifiers with the associated counterparty and contact information; affiliates of the counterparties that also are counterparties to QFC transactions; affiliates of the institution that are counterparties to QFC transactions, specifically indicating which affiliates are direct or indirect subsidiaries of the institution; and portfolio location identifiers with the associated booking locations.

For each QFC, the institution must maintain copies in a central location or data base in the United States of certain agreements, including active master netting agreements, and other QFC agreements between the institution and its counterparties that govern the QFC; active or "open" confirmations, if the position has been confirmed; credit support documents; and assignment documents, if applicable. The institution also must maintain a legal entity organizational chart; an organizational chart of all personnel involved in QFC-related activities at the institution, parent and affiliates; and a list of vendors supporting the QFC-related activities.

IV. Requests for Comment:

For purposes of the final rule, the preamble to this NPR requests comments on various issues regarding the scope and QFC recordkeeping requirements of the NPR. These specific requests are as follows:

1. Whether the definition of "troubled condition" in the proposed rule should be modified in the final rule to include any insured depository institution that has received a

composite rating as determined by its appropriate Federal banking agency in its most recent examination, of a 3 under the Uniform Financial Institution Rating System?

2. Whether the QFC recordkeeping requirements in this proposed rule should be applied in the final rule to cover all institutions, regardless of whether they are in a troubled condition? Alternatively, should the proposed rule be applied to cover all institutions, regardless of whether they are in a troubled condition, if they meet certain quantitative thresholds? Possible thresholds are outlined in the following question. Such an expansion of the scope of the proposed rule would be consistent with the important role that the availability of this information will have in the case of the appointment of a receiver or conservator in facilitating an orderly resolution of a failed institution and the reduction of the losses of the deposit insurance fund. Delaying the obligation for such recordkeeping until an institution is in a troubled condition increases the risks of disruption and the potential for losses to the deposit insurance fund. In addition, the requirements imposed by this proposed rule are consistent with the data and records necessary for the safe and sound management of the risks arising from QFC activities. The absence of such prudent management practices increases the risks to the deposit insurance fund. The FDIC's general authority to promulgate rules to protect the deposit insurance fund would provide additional support for this expanded coverage.[3]

3. Whether the QFC recordkeeping requirements in this proposed rule should be applied in the final rule only to institutions that meet certain quantitative thresholds, for example, including (i) the total consolidated assets of the institution exceed a certain threshold (e.g., a minimum total asset size of the institution of $2 billion or more); (ii) the institution's holding of QFCs exceeds a certain total notional or principal amount;

[3] See 12 U.S.C. 1819(a)(Tenth); 12 U.S.C. 1821(a)(4)(A).

(iii) the institution is a party to no fewer than 10 open positions, or (iv) the total notional or principal amount of QFCs held by the institution constitute more than a certain percentage of tier 1 and tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency, based on the institution's most recent consolidated Report of Condition and Income (e.g., greater than 20 percent of the institution's tier 1 and tier 2 risk-based capital)? In addition, should the FDIC consider other relevant factors such as the total number of QFC transactions by the institution, the types of QFCs executed by the institution, and the complexity of the QFC positions executed by the institution? Alternatively, should institutions below thresholds of the types described in this question be required to comply with the substantive requirements in proposed part 370 and section B of proposed Appendix A, but be excused from the requirements in Tables A1 and A2 of proposed Appendix A that records be maintained in electronic form?

4. Should the QFC position level data fields in Table A1 of proposed Appendix A be required of affiliates of institutions subject to the proposed rule? Alternatively, should the QFC position level data fields in Table A1 of proposed Appendix A be required for affiliates of the institution that are counterparties to QFC transactions where such transactions are subject to a master agreement that also governs QFC transactions entered into by the institution?

5. Are there additional recordkeeping requirements or modifications to the proposed QFC recordkeeping requirements that would better reflect current internal risk management concerns of institutions?

6. Should the data requirements in proposed Appendix A be tailored to fit specific QFC categories (e.g., repurchase agreements and swap contracts)?

7. Should the FDIC revise its current definition of "troubled condition" in 12 CFR 303.102(c) to include the definition of "troubled condition" in this proposed rule?

8. The FDIC requests comment concerning (i) the extent to which contracts of institutions and their affiliates are subject to master netting agreements, cross-collateralization agreements, or other master agreements that affect the institutions' net positions or collateral sufficiency with respect to a counterparty;[4] (ii) the extent to which contracts of counterparties and their affiliates are subject to master netting agreements, cross-collateralization agreements, or other master agreements that affect the counterparties' net positions or collateral sufficiency; and (iii) the processes by which such impacts are monitored by institutions, counterparties, and their affiliates, respectively. Please note that such cross-affiliate netting across the insured institution in receivership and its affiliates may be contrary to the provisions of the FDI Act governing the liabilities of the receivership and the distribution of the proceeds of the sale or liquidation of the insured institution's assets if such netting would disadvantage the insured institution and impose losses on the institution in receivership otherwise attributable to contracts by the institution's affiliates.

9. Do any of the data fields required in Tables A1 and A2 of proposed Appendix A call for information that is not relevant to the institutions' and counterparties' legal and economic positions regarding their QFC portfolios? Also, please provide any modifications of the data fields in Tables A1 and A2, in addition to the information

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[4] This situation might occur, for example, if an institution and its affiliates were treated as a single party under a master netting agreement, whereby their respective positions would be netted against one another and that net position, in turn, would be netted against the counterparty's position.

required in section B of proposed Appendix A that would be appropriate for the appropriate Federal banking agency and the FDIC to better monitor QFCs entered into by institutions, counterparties, and affiliates of institutions and counterparties that are covered by section B.1 of proposed Appendix A.

10. Under section 370.1(c) of the proposed rule, an insured institution must comply with this rule and Appendix A within 30 days after written notification by the institution's appropriate Federal banking agency or the FDIC that it is in a "troubled condition" as defined in the proposed rule. Should the FDIC include in the final rule an approval procedure for requests for an extension of the 30 day deadline from institutions with an aggregate amount of QFCs beyond a certain threshold and based on specific dates for compliance?

11. Should Appendix A be amended to include requirements for a listing of the institution's QFC-related portfolios, those portfolios' risk information, and the specific counterparties associated with those portfolios?

Attachments