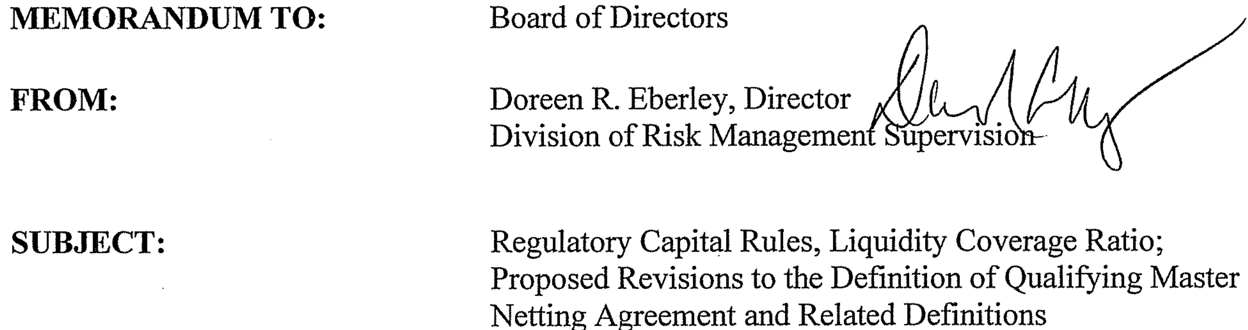
January 21, 2015



MEMORANDUM TO: Board of Directors

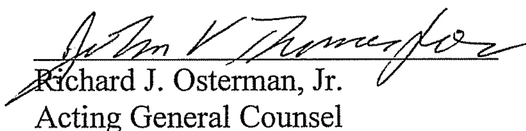
FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Regulatory Capital Rules, Liquidity Coverage Ratio; Proposed Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions

Summary: The International Swaps and Derivative Association ("ISDA") recently published a protocol ("ISDA Protocol") to amend its standard documentation, which governs a significant portion of over-the-counter ("OTC") derivatives transactions. The modifications in the ISDA Protocol provide, among other things, for a limited stay of termination rights and other remedies in connection with certain insolvency or resolution proceedings. In light of these changes, staff is seeking the approval of the FDIC's Board of Directors ("FDIC Board") to publish the attached FDIC notice of proposed rulemaking ("NPR" or "FDIC proposed rule"). This NPR would amend the definition of qualifying master netting agreement, and other related definitions, under the regulatory capital and the liquidity coverage ratio regulations in order to conform with the modifications to ISDA's standard documentation in the ISDA Protocol. This NPR is expected only to apply to banking organizations that engage in a substantial amount of cross-border derivatives transactions; therefore, community banks generally would not be affected by the proposed rule changes.

Recommendation: That the FDIC Board approve the attached NPR and authorize its publication in the *Federal Register* for a comment period ending 60 days after its publication in the *Federal Register*.

Concur:



Richard J. Osterman, Jr.
Acting General Counsel

Discussion:

Background

A significant portion of bilateral financial contracts entered into by globally active, U.S financial institutions permit the counterparties to liquidate, terminate, or accelerate the contract upon the failure of a counterparty or an affiliate of such counterparty. The exercise of these contractual rights upon the failure of a globally active financial institution, however, could frustrate the orderly resolution of the financial institution and pose risks to financial stability. To address these concerns, the United States Congress provided for a limited stay on the exercise of these termination rights with regard to qualified financial contracts (such as OTC derivatives, repo-style transactions, and margin loans) with insured depository institutions in resolution under the Federal Deposit Insurance Act ("FDI Act")[1] and, subsequently, with financial companies in resolution under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2]

Following the most recent financial crisis, foreign financial regulatory agencies have also recognized that the orderly cross-border resolution of a globally active financial company requires that all home jurisdictions for globally active financial institutions need to have effective national resolution regimes to resolve failing financial companies in an orderly manner. In furtherance of that goal, the Bank Recovery and Resolution Directive ("BRRD") of the European Union ("EU") was finalized. The BRRD establishes an EU framework for the recovery and resolution of financial companies and, by January 1, 2015, requires EU resolution authorities to

[1] 12 U.S.C. § 1821(e)(13).
[2] 12 U.S.C. § 5390(c)(16).

have in place resolution regimes with a broad range of powers to resolve a financial institution that is no longer viable.

In light of the adoption of these and other foreign resolution regimes, which provide for limited stays that are substantially similar[3] to the stays in Title II of the Dodd-Frank Act and the FDI Act, ISDA recently published a protocol ("ISDA Protocol") to amend its standard master agreement ("ISDA Master Agreement"). The ISDA Master Agreement is the form agreement typically used by private parties of OTC derivative transactions. Like other qualified financial contracts, many of the OTC derivatives executed under ISDA Master Agreements, including those entered into by globally active financial institutions, allow a party to terminate the transaction immediately if its counterparty, or an affiliate of its counterparty, enters insolvency or similar proceedings. The ISDA Protocol provides for a limited stay of termination rights and other remedies in financial contracts in connection with an insolvency or resolution proceeding. Specifically, the ISDA Protocol would apply the provisions of Title II of the Dodd-Frank Act or the FDI Act, as appropriate, concerning stays of termination rights and other remedies in qualified financial contracts entered into by U.S. financial companies, including insured banks, if counterparties to such transactions are not subject to U.S. banking law. It would also apply similar provisions of the laws and regulations of certain EU member countries that have implemented the BRRD to counterparties of financial companies in those countries. Thus, the ISDA Protocol would limit the rights of counterparties to exercise termination rights and other remedies in financial contracts to the same extent that those rights would be limited under the

[3] The BRRD provides for a 48-hour limited stay of the termination rights upon the event of insolvency or resolution in financial contracts which could be shorter than the one-business day stay for qualified financial contracts under the FDI Act and Title II of the Dodd-Frank Act.

sovereign resolution regime applicable to their counterparties or, in certain circumstances, their counterparties' affiliates.

The capital and liquidity rules of the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, "the agencies"), provide favorable treatment to OTC derivatives that are subject to a qualifying master netting agreement [4] ("QMNA").[5] The agencies have defined a qualifying master netting agreement to permit a banking organization to terminate, apply close-out netting, and promptly liquidate or set-off collateral upon an event of default of the counterparty (default rights), thereby reducing its counterparty exposure and market risks. The current definition of "qualifying master netting agreement" recognizes that default rights may be stayed if the financial company is in receivership, conservatorship, or resolution under Title II of the Dodd-Frank Act,[6] the FDI Act,[7] or under any similar insolvency law applicable to government sponsored enterprises (GSEs),[8] in recognition of the benefits of orderly resolution resulting from these regimes. However, the current definition of "qualifying master netting agreement" does not recognize that default rights may be stayed where a master netting agreement is subject to limited stays under non-U.S. special resolution regimes or where counterparties agree through contract that a special resolution regime would apply. As a result, a master netting agreement that binds parties to the resolution laws of a foreign jurisdiction that

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[4] See 12 CFR 324.2 and 12 CFR 329.3 for the definition of qualifying master netting agreement.
[5] *See e.g.*, 12 CFR 324.34(a)(2); 12 CFR 329.32(c); 329.33(b) (net derivative cash outflows and inflows amounts).
[6] See 12 U.S.C. 5390(c)(8)-(16).
[7] See 12 U.S.C. 1821(e)(8)-(13).
[8] Generally under the agencies' regulatory capital rules, government-sponsored enterprise means an entity established or chartered by the U.S. government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. government. See regulatory capital rules Section 2.

provides for limited stays would disqualify such agreement from being a QMNA and from receiving favorable treatment under the U.S. capital and liquidity rules.

<u>FDIC Proposed Rule</u>

The FDIC proposed rule would amend the definitions of "collateral agreement," "eligible margin loan," "qualifying master netting agreement," and "repo-style transaction" in the FDIC's regulatory capital rules and the liquidity coverage ratio rule to ensure that the regulatory capital and liquidity treatment of OTC derivatives, repo-style transactions, eligible margin loans, and other collateralized transactions are unaffected by adoption of various foreign special resolution regimes and the ISDA Protocol. Specifically, the FDIC proposed rule would amend these definitions to provide that a relevant netting agreement, collateral agreement, or executing agreement may provide for a limited stay or avoidance of rights where the agreement is subject by its terms to, or incorporates, any of the resolution regimes enumerated in the FDIC proposed rule's revisions to the aforementioned definitions, including Title II of the Dodd-Frank Act, the FDI Act, and any similar foreign resolution regime that is substantially similar to the resolution regimes in Title II of the Dodd-Frank Act or the FDI Act. The FDIC expects to make an evaluation of whether a foreign resolution regime is substantially similar to these U.S. laws jointly with the FRB and OCC.

The NPR would be expected only to apply to banking organizations that adhere to the ISDA Protocol. To date, 18 globally active banking organizations have adhered to the ISDA Protocol, including several U.S. banking organizations. Such institutions generally engage in a substantial amount of cross-border derivatives transactions. Community banking organizations generally will not fall into this category and, therefore, should not be affected by the proposed rule changes.

Joint Interim Final Rule Issued by the FRB and OCC

In December 2014, the FRB and the OCC adopted a joint interim final rule covering changes to the definition of qualifying master netting agreement in their regulatory capital rules and liquidity coverage ratio final rules and changes to related definitions that are identical to the changes proposed in this NPR. This joint IFR will only apply to FRB-supervised and OCC-supervised banking organizations. This joint IFR is effective immediately upon publication in the *Federal Register* because ISDA's revised standard documentation is effective for certain globally active, U.S. financial institutions on January 1, 2015.

The FDIC is issuing an NPR regarding this matter, rather than an IFR, because the effective date of the ISDA Protocol does not present a sufficient exigency with respect to FDIC-supervised institutions.

Conclusion

FDIC staff recommends that the FDIC Board adopt the attached NPR and authorize its publication in the *Federal Register* for a comment period ending 60 days after its publication in the *Federal Register*.

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