September 20, 2016

MEMORANDUM TO: Board of Directors

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

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

Summary: Staff recommends that the FDIC's Board of Directors ("FDIC Board") approve for publication in the *Federal Register* the attached final rule ("final rule" or "FDIC final rule"). This final rule amends the definition of "qualifying master netting agreement," and other related definitions, under the FDIC's regulatory capital and the liquidity coverage ratio rules. The final rule's amendments were proposed in January 2015 to ensure that the regulatory capital and liquidity treatment of certain financial contracts generally would not be affected by implementation of special resolution regimes in non-U.S. jurisdictions that are substantially similar to the U.S. resolution framework, or by changes to the International Swaps and Derivative Association ("ISDA") Master Agreement that provide for contractual submission to such regimes. The final rule would be expected only to affect a small number of FDIC-supervised institutions that enter into over-the-counter ("OTC") derivatives with foreign counterparties.

The final rule's amendments are substantively identical to amendments adopted by the Board of Governors of the Federal Reserve System ("Federal Reserve") and the Office of the Comptroller of the Currency ("OCC") in a joint interim final rule issued in December 2014. The amendments will also align the FDIC's "qualified master netting agreement" definition with the definition of "eligible master netting agreement" adopted by the FDIC, OCC, Federal Reserve,

Concur:

Charles Yi
General Counsel

Federal Housing Finance Agency, and Farm Credit Administration in a joint final rule establishing margin requirements for non-cleared swaps ("swap margin rule") in November 2015.

Recommendation: That the FDIC Board approve the attached final rule and authorize its publication in the *Federal Register* with the date of *Federal Register* publication as the effective date.

Discussion:

Background

A significant portion of bilateral financial contracts entered into by globally active, U.S financial institutions are "qualified financial contracts" (QFCs) such as OTC derivatives, repo-style transactions, and margin loans. QFCs are exempt from the automatic stay in bankruptcy, and therefore QFC counterparties are permitted to take actions that are unavailable to other creditors to liquidate, terminate, or accelerate contracts upon the insolvency or resolution of a counterparty, or an affiliate of a 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 by QFC counterparties of these termination rights with insured depository institutions in resolution under the Federal Deposit Insurance Act ("FDI Act") [1] and, subsequently, with financial companies in resolution

[1] 12 U.S.C. § 1821(e)(13).

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 in 2014. The BRRD established an EU framework for the recovery and resolution of financial companies and required EU resolution authorities to have in place resolution regimes as early as January 1, 2015, with a broad range of powers to resolve a financial institution that is no longer viable.[3]

In light of the adoption of these and other foreign resolution regimes,[4] which provide for limited stays that are substantially similar[5] to the stays in Title II of the Dodd-Frank Act and the FDI Act, ISDA launched in 2014, a protocol (as subsequently expanded in November 2015, the "ISDA Protocol")[6] under which parties to its standard master agreement ("ISDA Master Agreement")[7] and non-ISDA standard securities financing transaction documentation[8] may

[2] 12 U.S.C. § 5390(c)(16).
[3] Other countries, such as Japan and Switzerland, have adopted similar resolution regimes.
[4] At this date, the process of transposition of the BRRD into EU members' national legislation is largely complete.
[5] 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.
[6] The November 2015 ISDA Protocol is also referred to as the "ISDA 2015 Universal Dealer Protocol."
[7] The ISDA Master Agreement is the form agreement typically used by private parties for repo and repo-like 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.
[8] Industry standard documentation for securities financing transactions between counterparties that adhere to the ISDA Protocol is automatically amended to stay certain default rights and other remedies provided under the ISDA Master Agreements.

amend current agreements to provide for a stay of termination rights and other remedies.[9] The ISDA Protocol provides a multilateral mechanism whereby the parties agree to a limited stay of termination rights and other remedies in financial contracts in connection with an insolvency or resolution proceeding.[10] Specifically, under the ISDA Protocol, parties agree that 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 depository institutions, apply even if those transactions are not subject to U.S. law or are being enforced in a foreign court. The ISDA Protocol 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 limits 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 sovereign resolution regime applicable to their counterparties or, in certain circumstances, their counterparties' affiliates.

In addition, the ISDA Protocol provides for limited stays of termination rights and other remedies for defaults related to affiliate insolvency proceedings under a limited number of U.S.

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[9] On November 5, 2013, the FDIC, the Bank of England, the German Bundesanstalt für Finanzdienstleistungsaufsicht and the Swiss Financial Market Supervisory Authority wrote a joint letter to ISDA requesting that standard ISDA documentation provide for short-term suspension of early termination rights and other remedies on the basis of the commencement of an insolvency or resolution proceeding, or exercise of a resolution power, with respect to a counterparty or its specified entity, guarantor or credit support provider. Shortly thereafter the Japanese Financial Services Agency sent a letter to ISDA in support of the joint letter. The ISDA working group subsequently consulted representatives from these authorities (as well as the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York and the Office of the Comptroller of the Currency in the United States and French Autorité de contrôle prudentiel et de résolution) as it worked to develop the ISDA 2014 Resolution Stay Protocol in 2014 to amend OTC derivatives documented under ISDA Master Agreements. In 2015, the same group developed the Securities Financing Transaction Annex (the "SFT Annex") , to amend repurchase agreements and securities lending transactions, and the ISDA 2015 Universal Dealer Protocol, which includes the substance of both the ISDA 2014 Resolution Stay Protocol and the SFT Annex.

[10] As of July 14, 2016, 217 parties, including several of the largest U.S. banking organizations, have adhered to the ISDA Protocol and thereby modified their ISDA Master Agreements. The effective date of certain provisions of the 2015 ISDA Protocol was January 1, 2016.

insolvency regimes. ISDA Master Agreements and securities financing transactions (documented under industry standard documentation for such transactions) between counterparties that adhere to the ISDA Protocol are automatically amended to stay certain default rights and other remedies provided under the agreement. The effective date of certain provisions of the ISDA Protocol was January 1, 2016.

The capital and liquidity rules of the OCC, the Federal Reserve, and the FDIC (collectively, "the agencies") provide favorable treatment for OTC derivatives that are subject to a qualifying master netting agreement[11] ("QMNA").[12] The agencies have defined a QMNA as a netting agreement that, among other things, permits 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 definition of QMNA under the FDIC's current capital rules 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,[13] the FDI Act,[14] or under any similar insolvency law applicable to government sponsored enterprises (GSEs),[15] in recognition of the benefits of orderly resolution resulting from these regimes. However, the FDIC's current definition of QMNA 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 an FDIC-supervised institution to the resolution laws of a foreign jurisdiction that

[11] *See* 12 CFR 324.2 and 12 CFR 329.3 for the definition of qualifying master netting agreement.
[12] *See e.g.*, 12 CFR 324.34(a)(2); 12 CFR 329.32(c); 329.33(b) (net derivative cash outflows and inflows amounts).
[13] *See* 12 U.S.C. 5390(c)(8)-(16).
[14] *See* 12 U.S.C. 1821(e)(8)-(13).
[15] 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* 12 CFR 324.2.

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

Summary of Comments on the January 2015 NPR

In January 2015, the FDIC published a notice of proposed rulemaking, proposing amendments to the definition of QMNA in the FDIC's capital and liquidity rules, and related terms in the FDIC's capital rules (the "January 2015 NPR").[16] The FDIC received three comments on the January 2015 NPR. One comment was generally supportive of the proposed rule in the January 2015 NPR as a necessary technical amendment that would promote the objective of establishing effective resolution regimes for globally active financial companies.

Two of the commenters noted the absence of reference to any stays authorized by state insurance law in the proposed definition of "qualifying master netting agreement." Some States' laws applicable to the conservation, rehabilitation, liquidation and insolvency of insurance companies may provide authority for close-outs of derivative and similar financial contracts to be stayed for twenty-four hours, similar to stays under the FDIA and DFA. The commenters maintained that failure to include stays under state insurance resolution proceedings within the definition of "qualifying master netting agreement" might adversely affect derivative and similar financial transactions between state-regulated insurance companies and their counterparties, including FDIC-supervised institutions. As such stays may be analogous to similar stays under the other resolution authorities referenced in the rule's definition, the commenters recommend that state law should also be referenced.

[16] *See* 80 FR 5063 (January 30, 2015).

The narrow purpose of amending the definition of "qualifying master netting agreement" in the proposed rule and this final rule is to maintain the regulatory capital and liquidity treatment of certain financial contracts as unaffected by the ISDA Master Agreement and stays by non-U.S. resolution authorities. The FDIC has considered the comments for purposes of the final rule and has determined that the commenters raise an issue that is beyond that limited purpose.[17]

FDIC Final Rule

This final rule would adopt the amendments proposed in the January 2015 NPR. The FDIC final rule would amend the definition of QMNA in the capital and liquidity rules, and the definition of "collateral agreement," "eligible margin loan," and "repo-style transaction" in the FDIC's regulatory capital rules 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 final 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 final 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

[17] Although the issue is currently outside the scope of this rulemaking, staff may consider the treatment of derivative and other similar financial contracts subject to stays in state insurance resolution proceedings in the context of further rulemaking, in consultation with the other agencies and with State insurance regulatory authorities.

foreign resolution regime is substantially similar to these U.S. laws jointly with the Federal Reserve and the OCC.

The FDIC final rule would be expected only to apply to banking organizations that adhere to the ISDA Protocol or 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 final rule's changes to the definition of QMNA in the regulatory capital and liquidity rules and related definitions in the regulatory capital rules.

In December 2014, the Federal Reserve and the OCC issued a joint interim final rule ("IFR") covering changes to the definition of QMNA in their regulatory capital rules and liquidity coverage ratio final rules and changes to related definitions that are substantively identical to the changes in this FDIC final rule.[18] This joint IFR applies to Federal Reserve-supervised and OCC-supervised banking organizations. This joint IFR was effective on January 1, 2015.

In addition to giving contractual effect to limited stays of termination rights under special resolution regimes on a cross-border basis, the ISDA Protocol also provides for limited stay of termination rights for cross-defaults resulting from affiliate insolvency proceedings under a limited number of U.S. general insolvency regimes, including the U.S. bankruptcy code. This provision takes effect upon the effective date of implementing regulations in the United States. To the extent the federal banking agencies implement regulations to give effect to these provisions of the ISDA Protocol, the FDIC will consider further amending the definition of "qualifying master netting agreement" in the regulatory capital and liquidity rules and the definition of "collateral agreement", "repo-style transaction" and "eligible margin loan" in the

[18] *See* 79 FR 78287 (December 30, 2014).

regulatory capital rules. The qualified master netting agreement definition in the FDIC's capital and liquidity rules also relates to the eligible master netting agreement definition in the swap margin rules adopted in November 2015.[19] The swap margin rule establishes margin requirements for non-cleared swaps entered into by an entity, supervised by one of the adopting agencies that is also registered with the Commodity Futures Trading Commission or the Securities and Exchange Commission, as a dealer or major participant in non-cleared swaps (such entities are referred to in the swap margin rule as "covered swap entities.") The swap margin rule allows a covered swap entity to net variation margin and initial margin requirements for non-cleared swaps subject to the rule when such swaps are subject to an "eligible master netting agreement" between the covered swap entity and its counterparty.

The swap margin rule's definition of "eligible master netting agreement" is substantially the same as the definition of "qualified master netting agreement" as amended by this final rule.

Effective Date

The Administrative Procedure Act ("APA") requires that a final rule be published in the *Federal Register* no less than 30 days before its effective date unless good cause is found and published with the final rule.[20] Having the final rule take effect on the date of publication in the *Federal Register* will allow affected state nonmember banks to use the definition of qualified master netting agreement as amended by the final rule when they file their respective call report for the third quarter period ending on September 30, 2016. Staff recommends that the final rule take effect on the day it is published in the *Federal Register*.

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[19] *See* 80 FR 74840 (November 30, 2015).
[20] *See* 5 U.S.C. § 553(d).

Conclusion

FDIC staff recommends that the FDIC Board adopt the attached final rule and authorize its publication in the *Federal Register* with an effective date as of its date of publication.

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