The Systemic Risk Council

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
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Comments@fdic.gov

SUBMITTED VIA ELECTRONIC MAIL

March 28, 2015

RE:Regulatory Capital Rules, Liquidity Coverage Ratio: Proposed Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions (RIN 3064-AE30)

Dear Mr. Feldman:

The Systemic Risk Council (the Council or we)[1] appreciates the opportunity to comment on the proposal of the Federal Deposit Insurance Corporation (the FDIC) to amend certain definitions under the regulatory capital and liquidity coverage ratio rules applicable to FDIC-supervised banking organizations (the Proposed Rule),[2] in order to ensure that the favorable capital and liquidity treatment currently accorded to various derivatives and collateralized transactions is not disrupted by the adoption of certain foreign special resolution regimes or the International Swaps and Derivatives Association Resolution Stay Protocol (the ISDA Protocol).

The Council supports adoption of the Proposed Rule, which promotes the common objective—shared by the FDIC and the other federal banking regulatory agencies as well as the Council—of establishing effective resolution regimes for globally active financial companies.[3] Absent adoption of the Proposed Rule, the discrepancy between the treatment of (i) qualifying master netting agreements (QMNAs) subject to a stay or avoidance of rights only upon default under U.S. special resolution and (ii) QMNAs subject to foreign *yet substantially similar* regimes would effectively penalize banks for the international implementation of a policy with which the U.S. regulatory community broadly agrees, leading to an odd result where similar credit risk mitigation measures receive entirely different regulatory capital treatment. Notwithstanding the Council's endorsement of the Proposed Rule as a necessary technical amendment to the current

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[1] The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed by the CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. and global capital markets, with a focus on systemic risk. The statements, documents, and recommendations of the private sector, volunteer Council do not necessarily represent the views of its supporting organizations. The Council works collaboratively to seek agreement on each of its recommendations. This letter fairly reflects the consensus views of the Council but does not bind its individual members.
[2] Regulatory Capital Rules, Liquidity Coverage Ratio: Proposed Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 80 Fed. Reg. 5063 (Jan. 30, 2015) [henceforth, the Proposed Rule].
[3] *See* Council Letter to the Financial Stability Board (Dec. 1, 2014), available at http://www.systemicriskcouncil.org/wp-content/uploads/2014/12/FSB-Cross-Border-Letter.pdf.

netting rules, we believe that the impact of close-out netting on systemic risk mitigation and the current theory and practice for calculating regulatory capital relief for close-out netting should be reassessed in the near future to determine their ongoing appropriateness.

1. Summary of the Proposed Rule

The Proposed Rule would amend the definition of "qualifying master netting agreement" and make conforming changes to the definitions of "collateral agreement," "eligible margin loan," and "repo-style transaction."[4] Under the FDIC's current rules, a QMNA may provide for a "limited stay" or "avoidance of rights" upon the default of a counterparty based upon receivership, conservatorship, or resolution *exclusively* under the Federal Deposit Insurance Act (the FDIA),[5] Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Title II),[6] or similar laws applicable to U.S. government-sponsored enterprises, as the case may be.[7] Under the proposal, a QMNA could also provide for a limited stay or avoidance of rights upon default where it is subject to or incorporates any foreign special resolution regime that is "substantially similar" to Title II.[8] The determination of whether a foreign special resolution regime is "substantially similar" would be made jointly by the FDIC, the Board of Governors of the Federal Reserve System (the Board), and the Office of the Comptroller of the Currency (the OCC, and together with the FDIC and the Board, the agencies) and would include consideration of, among other factors, creditor safeguards or protections and the length of the stay under such a regime.[9]

2. The Proposed Rule encourages international consistency in the adoption of special resolution regimes consistent with the goals of the G-20 and the Financial Stability Board.

The Proposed Rule would maintain equivalent capital and liquidity treatment among QMNAs that differ primarily in the jurisdiction of any special resolution regime to which they are subject. We applaud the FDIC for recognizing that, without the Proposed Rule's amendments, the currently applicable definitions draw a distinction without a difference between the U.S. special resolution regimes and substantially similar foreign regimes. More importantly, we commend the FDIC for encouraging the salutary goal of "implement[ing] consistent, national resolution regimes on a global basis[, which] furthers the orderly resolution of internationally active financial companies and enhances financial stability."[10] Permitting the regulatory capital and liquidity coverage ratio rules to drive a wedge between U.S. and foreign regulators on this issue would not only undermine the principle of international regulatory comity; it would constitute an unnecessary distraction at a time when G-20 jurisdictions are finalizing critical rules to dispel the notion that certain large financial institutions are insusceptible to orderly resolution and thus "too big to fail."

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[4] *Id.*, at 5066.
[5] 12 U.S.C. § 1811 *et seq.* (2012).
[6] Public Law 111-203, 124 Stat. 1376, 1442 (July 21, 2010).
[7] 12 C.F.R. §§ 324.2 and 329.3.
[8] Proposed Rule, *supra* n. 2, at 5063.
[9] *Id.*, at 5066. In December 2014, the Board and the OCC announced the adoption of a joint interim rule that is identical to the Proposed Rule. *See*, Press Release, *Agencies Announce Rules to Reflect ISDA Protocol in Regulatory Capital and Liquidity Coverage Ratio Rules* (Dec. 16, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20141216a.htm.
[10] Proposed Rule, *supra* n. 2, at 5066.

3. The Proposed Rule ensures that similar regulatory capital treatment will be afforded for similar credit risk mitigation.

The agencies' regulatory capital and liquidity coverage ratio rules currently permit a banking organization to measure its credit risk exposure under certain types of financial contracts on a net basis and to recognize the risk-mitigating effects of financial collateral for other types of exposures, so long as those financial contracts are subject to a QMNA.[11] Measuring credit risk exposure on a net rather than gross basis results in lower capital requirements.[12] The rules define a QMNA as a netting agreement that permits a banking organization to terminate, apply close-out netting, and promptly liquidate or set-off collateral upon occurrence of a counterparty event of default.[13] The FDIC's rules recognize that such "rights upon default" may be stayed in limited circumstances—*e.g.*, when a banking organization is in receivership, conservatorship, or resolution under the FDIA or Title II—yet still accord QMNAs favorable capital treatment.

However, the current definition of "qualifying master netting agreement" and related terms do *not* provide the same capital treatment where rights upon default are subject to limited stays under a *foreign* special resolution regime or where counterparties to a financial contract agree to apply a U.S. or foreign special resolution regime.[14] Without the Proposed Rule, therefore, FDIC-supervised banking organizations employing similar credit risk mitigants would potentially be afforded entirely inconsistent regulatory capital treatment.

4. *The Proposed Rule appropriately reflects relevant legal and regulatory developments abroad.*

When the relevant definitions were originally adopted by the agencies, no foreign jurisdiction had yet adopted a relevant special resolution regime. Similarly, the ISDA Protocol was not yet in place. Recently, however, the European Union has finalized its Bank Recovery and Resolution Directive (the BRRD), which prescribes features of a special resolution regime that E.U. member states should implement.[15] In addition, several U.S. banking organizations have recently announced that they will adopt the ISDA Protocol, which amends the terms of the ISDA Master Agreement for bilateral over-the-counter derivatives transactions to stay certain rights upon default and provides certain other remedies.[16] Most provisions of both the BRRD and the ISDA Protocol took effect on January 1, 2015.[17]

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[11] *Id*., at 5063.

[12] The OCC has reported that legally enforceable bilateral netting agreements allowed the four banks with the largest notional derivatives positions (Citibank, N.A., JPMorgan Chase Bank, N.A., Bank of America, N.A., and Goldman Sachs Bank USA) to reduce the gross positive fair value of their netted derivatives contracts (*i.e.*, derivatives receivables) by 88.6% in the third quarter of 2014. *See*, OCC, *OCC's Quarterly Reports on Bank Trading and Derivatives Activities, Third Quarter 2014, available at* http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/derivatives-quarterly-report.html (the OCC Report).

[13] *See* 12 C.F.R. § 3.2 (OCC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 324.2 (FDIC).

[14] Proposed Rule, *supra* n. 2, at 5063-4.

[15] Directive 2014/59/EU of the European Parliament and of the Council of the European Union establishing a framework for the recovery and resolution of credit institutions and investment firms (May 15, 2014), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN. The BRRD is generally designed to be consistent with the *Key Attributes of Effective Resolution Regimes for Financial Institutions*, which have been adopted by the Group of Twenty Finance Ministers and Central Bank Governors and the Financial Stability Board (the FSB).

[16] *See* ISDA Press Release, *Major Banks Agree to Sign ISDA Resolution Stay Protocol* (Oct. 11, 2014), available at http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol.

[17] *Id.*

The implementation of the BRRD and the ISDA Protocol generally parallels the steps taken in the United States to establish a special resolution regime under Title II. However, absent adoption of the Proposed Rule, a QMNA that permits rights upon default to be stayed under a special resolution regime implemented pursuant to the BRRD or that incorporates the ISDA Protocol would no longer satisfy the current definition of a "qualifying master netting agreement." The loss of favorable treatment for netting would result in "considerably higher capital and liquidity requirements" for affected organizations,[18] notwithstanding the broad consistency of the BRRD and the ISDA Protocol with the objectives of the U.S. special resolution regime under Title II and the FDIA. The Council thus believes that the current definitions should reflect these new developments.

> *5. More broadly, the impact of close-out netting on systemic risk mitigation and the current theory and practice for calculating regulatory capital relief for close-out netting should be reassessed to determine their ongoing appropriateness.*

Although the Proposed Rule resolves a critical technical deficiency in the current netting rules, there remain several practical questions regarding the effect that the expanded implementation and cross-referencing of special resolution regimes may have on the risk exposure of FDIC-insured depository institutions when their rights upon a counterparty's default are stayed or avoided.[19] The Proposed Rule therefore requests public comment regarding, in general, how cross-border netting agreements performed during the financial crisis, what legal and operational impediments remain to their effective functioning, and whether the current treatment of netted financial contracts accurately reflects the associated risks.[20]

There also remain larger policy questions whether the regulatory capital and liquidity coverage ratio rules accurately gauge the impact of netting as a mitigant of systemic risk. Indeed, while perhaps recognizing that the text of the Proposed Rule may not itself be a suitable vehicle for revisiting the basic theory and practice that underlie the netting rules, the FDIC has raised issues associated with QMNAs that the Council believes would be prudent to consider.

The Council acknowledges that netting can substantially reduce the exposure of a banking organization to a netted set of financial contracts, but we also observe that the remaining exposure is far from static. Close-out netting reduces credit risk, and it encourages growth in the size of bilateral netting, since the increase, if any, in the credit risk of a netted set of financial contracts is not proportional to the increase in the notional size of the netted set.[21] However, the

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[18] Proposed Rule, *supra* n. 2, at 5064.

[19] The ISDA Protocol also provides for a limited stay when the insolvency proceedings of an *affiliate* under U.S. *general* insolvency regimes, including the U.S. Bankruptcy Code, trigger a cross-default. However, since this provision of the ISDA Protocol does not take effect until implementing regulations are adopted, the FDIC appropriately has elected not to take any action with respect thereto in the Proposed Rule and instead has requested public comment regarding the matter. *Id.*, at 5067.

[20] Similarly, the Proposed Rule requests public comment regarding whether a foreign counterparty that was required to maintain a minimum level of total loss-absorbing capacity would have sufficient bail-in debt to fund its resolution pursuant to the BRRD. *See*, FSB, *Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution—Consultative Document* (Nov. 10, 2014), *available at* http://www.financialstabilityboard.org/wpcontent/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.

[21] According to the OCC, the four banks with the largest notional derivatives positions accounted for 75.6% of the dollar amount of the positions held by all FDIC-insured depository institutions, and the 25 largest such banks accounted for 99.8% of the total. *See*, OCC Report, at Table 3.

value-at-risk increases with notional size, and this exposure is a function of movement in market factors and other independent indices. Therefore, an individual financial contract may swing several times during its life between a gross positive and a gross negative fair value. Two-way cash flows are common, even on a daily basis, as collateral is transferred based on net credit exposure to the counterparty. In addition, the net credit exposure may be concentrated with respect to the bank counterparty, as indicated above, the type of end-user, or the underlying asset or reference index. Further, when a party to a financial contract posts non-cash collateral, changes in asset values may trigger margin calls. Finally, as the Proposed Rule suggests, parties' confidence in their close-out rights may be affected by the establishment of additional special resolution regimes and the strength of the assurances they receive from those regimes in exchange for the stay or avoidance of their rights upon default.

In sum, the Council supports adoption of the Proposed Rule as necessary to prevent unjustifiable inconsistencies in the application of the current netting rules among FDIC-supervised banking organizations and to avoid undermining global financial reform efforts. That said, we believe that it is important not to lose sight of the volatility that underlies QMNAs and to consider from time to time how well the regulatory capital and liquidity coverage ratio rules reflect the credit risk, market risk, and liquidity risk in a netted set of financial contracts.

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Respectfully submitted,

Sheila Bair, Chair

On behalf of the Systemic Risk Council

www.systemicriskcouncil.org

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* Affiliations are for identification purposes only. Council members participate as individuals, and this letter reflects their own views and not those of the organizations with which they are affiliated.