Client Alert

January 12, 2015

Federal Reserve Board and OCC Issue Interim Final Rule Amending U.S. Bank Capital and Other Rules to Account for Global Implementation of Bank Special Resolution Regimes

By Julian Hammar

On December 16, 2014, the Office of the Comptroller of the Currency ("OCC") and the Board of Governors of the Federal Reserve System ("Board") (collectively, "Agencies") issued an interim final rule ("IFR") amending the definition of "qualifying master netting agreement" ("QMNA") under the Agencies' regulatory capital and liquidity coverage ratio ("LCR") rules, as well as under the OCC's lending limits rule applicable to national banks and federal savings associations. The IFR also makes conforming amendments to the definitions of "collateral agreement," "eligible margin loan," and "repo-style transaction" under the capital rules.

The amendments are designed to ensure that the U.S. regulatory capital, liquidity and lending limits treatment of certain financial contracts will not be affected by implementation of special resolutions regimes in foreign jurisdictions or by the International Swaps and Derivative Association's ("ISDA's") Resolution Stay Protocol, published in November 2014 by ISDA. The IFR amends the capital rules applicable to "banking organizations," which include national banks, State member banks, savings associations and top-tier bank holding companies domiciled in the U.S. that are not subject to the Board's Small Bank Holding Company Policy Statement, as well as top-tier savings and loan holding companies (with certain exceptions) domiciled in the U.S.

The IFR is effective as of **January 1, 2015**, with comments due by **March 3, 2015**. It is available here.

BACKGROUND

The Agencies' regulatory capital rules[1] permit a banking organization to measure exposure from certain financial contracts on a net basis and recognize the risk-mitigating effect of "financial collateral" as defined in the rules[2] for other types of exposures, provided the contracts are subject to a QMNA. The Agencies have defined 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 an event of default of its counterparty ("default rights"), reducing the banking organization's counterparty exposure and market risks.[3] Generally, measuring the amount of exposure on a net

[1] The Regulatory Capital Rules are contained in 12 C.F.R. Part 3 (OCC) and 12 C.F.R. Part 217 (Board).

[2] Generally, under the Agencies' regulatory capital rules, financial collateral means collateral in the form of: (i) cash on deposit with the banking organization (including cash held for the banking organization by a third-party custodian or trustee); (ii) gold bullion; (iii) long-term debt securities that are not resecuritization exposures and that are investment grade; (iv) short-term debt instruments that are not resecuritization exposures and that are investment grade; (v) equity securities that are publicly traded; (vi) convertible bonds that are publicly traded; or (vii) money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily. In addition, the regulatory capital rules require that the banking organization have a perfected, first-priority security interest or, outside of the United States, the legal equivalent thereof (with the exception of cash on deposit and notwithstanding the prior security interest of any custodial agent). *See* Regulatory Capital Rules, section 2.

[3] *See* 12 C.F.R. §§ 3.2 and 217.2. The definition also applies to the LCR Rule, *see* 12 CFR §§ 50.3 and 249.3.

(rather than a gross) basis results in a lower measure of exposure and as a result a lower (more favorable) capital requirement.[4] Benefits also apply to netting derivative transactions subject to a QMNA under the LCR Rule[5] and the Lending Limits Rules.[6]

In addition, the regulatory capital rules permit banking organizations to recognize the risk mitigating effects of financial collateral received in a secured lending transaction, repo-style transaction, or eligible margin loan. In this regard, the definitions of "collateral agreement,"[7] "repo-style transaction"[8] and "eligible margin loan"[9] provide that the relevant documentation must provide for default rights similar to those as are required for QMNAs under the QMNA definition.[10]

Prior to the amendment by the IFR of the definitions of QMNA, collateral agreement, eligible margin loan, and repo-style transaction, the definitions recognized that default rights could be stayed only if a counterparty is a financial company that is placed in receivership, conservatorship, or resolution under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Federal Deposit Insurance Act ("FDI Act"), or similar insolvency law applicable to government sponsored enterprises ("GSEs").[11] Thus, for example, netting agreements that could be stayed under the Dodd-Frank Act, the FDI Act, or similar insolvency law applicable to GSEs would qualify for the favorable capital treatment for QMNAs. However, the definitions did not recognize that default rights could be stayed by special resolution regimes in foreign countries or where parties agree through contract, such as the ISDA Resolution Stay Protocol, that a special resolution regime would apply.

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[4] In addition, for purposes of the supplemental leverage ratio as applied to advanced approaches banking organizations, such a banking organization with multiple OTC derivatives with the same counterparty subject to a QMNA would be permitted to net for purposes of calculating the counterparty credit risk component of its total leverage ratio. In addition, such a banking organization would be permitted to not include in total leverage exposure cash variation margin received from the counterparty that has offset the mark-to-fair value of the derivative asset or cash collateral that is posted to such counterparty that has reduced the banking organization's on-balance sheet assets. *See generally* 12 C.F.R. Part 3 (OCC) and Part 217 (Board).

[5] Under the LCR Rule, a banking organization may calculate the net derivative outflow or inflow for derivatives that are subject to a QMNA by netting the contractual payments and collateral that it would give to or receive from the counterparty over a 30-day period. *See* 12 C.F.R. §§ 50.32(c)(1), 50.33(b)(1), 249.32(c)(1) and 249.33(b)(1). This results in a lower LCR denominator and liquidity requirement than if netting were not permitted and inflows or outflows were calculated on a gross basis as would be required in the absence of a QMNA.

[6] Under the Lending Limits rules, national banks and federal savings associations using an internal model method to calculate their counterparty credit exposure on derivatives transactions may calculate such exposure on a net basis for derivatives subject to a QMNA. *See* 12 C.F.R. § 32.9(b).

[7] A collateral agreement means a legal contract that specifies the time when, and circumstances under which, a counterparty is required to pledge collateral to a banking organization for a single financial contract or for all financial contracts in a netting set and confers upon the banking organization a perfected, first priority security interest (notwithstanding the prior security interest of any custodial agent) or the legal equivalent thereof, in the collateral posted by the counterparty under the agreement, subject to certain conditions. *See* 12 C.F.R. §§ 3.2 and 217.2.

[8] A repo-style transaction means a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the banking organization acts as agent for a customer and indemnifies the customer against loss, subject to certain conditions. *See* 12 C.F.R. §§ 3.2 and 217.2.

[9] An eligible margin loan means an extension of credit where the extension of credit is collateralized exclusively by liquid and readily marketable debt or equity securities or gold and the collateral is marketed-to-fair value daily and subject to daily maintenance margin requirements, subject to certain conditions. *See* 12 C.F.R. §§ 3.2 and 217.2.

[10] *See* 12 C.F.R. §§ 3.2 and 217.2.

[11] Generally under the regulatory capital rules, a GSE 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 C.F.R. §§ 3.2 and 217.2.

In May 2014, the European Union issued the Bank Recovery and Resolution Directive ("BRRD"), which sets forth aspects of special resolution regimes that EU member states should have implemented by December 31, 2014, with effect on January 1, 2015.[12] More recently in November 2014, ISDA published its Resolution Stay Protocol, which provides for amendments to the terms of ISDA Master Agreements to stay certain default rights and other remedies provided under such agreement.[13] Specifically, the ISDA Resolution Stay Protocol would apply the provisions of Title II of the Dodd-Frank Act and the FDI Act concerning limited stays of termination rights and other remedies in qualified financial contracts to ISDA Master Agreements between adhering counterparties, including adhering counterparties not otherwise subject to U.S. law. The Protocol also would apply substantially similar provisions of specified non-U.S. laws, such as the BRRD, to adhering counterparties not subject to such laws. A number of global financial institutions, including the largest U.S. banking organizations, have adhered to the ISDA Resolution Stay Protocol.[14] The relevant provisions of the ISDA Resolution Stay Protocol went into effect on January 1, 2015.

A master netting agreement the default rights under which may be stayed pursuant to the BRRD or that incorporates the amendments from the ISDA Resolution Stay Protocol would not qualify as a QMNA under the capital, LCR, and lending limits rules in the absence of an amendment to the QMNA definition. The result would be considerably higher capital and liquidity requirements for banking organizations and would require national banks and federal savings associations to measure their lending limits on a gross basis. Similarly, absent an amendment to the definitions of collateral agreement, eligible margin loan and repo-style transaction, a margin loan or repurchase, reverse repurchase or securities lending transaction conducted under an agreement that provides that a foreign special resolution regime applies or for which a banking organization's default rights may be stayed under such a regime would not qualify as a collateral agreement, eligible margin loan, or repo-style transaction that would receive benefits under the regulatory capital rules.

THE IFR

The IFR amends the definitions of QMNA, collateral agreement, eligible margin loan, and repo-style transaction in the agencies' regulatory capital rules and QMNA in the LCR rules. The amendments would allow a netting agreement or collateral agreement to provide that the exercise of default rights under such agreement may be stayed or avoided where the agreement is subject by its terms to, or incorporates, certain resolution regimes applicable to financial companies. These resolution regimes include Title II of the Dodd-Frank Act, the FDI Act, any similar insolvency law applicable to GSEs, or any similar foreign special resolution regime that provides for limited stays "substantially similar to" the stays provided for in the Dodd-Frank Act or the FDI Act.

The amendments are designed to ensure that the regulatory capital, liquidity, and lending limits treatment of OTC derivatives subject to QMNAs, repo-style transactions, eligible margin loans, and other collateralized transactions would remain unchanged by the adoption of similar foreign resolution regimes and the ISDA Resolution Stay Protocol. As discussed above, in the absence of the amendments, the definitions would only permit stays or

[12] *See* Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

[13] *See* ISDA 2014 Resolution Stay Protocol, available at http://www2.isda.org/functional-areas/protocol-management/protocol/20.

[14] *See* http://www2.isda.org/news/isda-publishes-2014-resolution-stay-protocol.

avoidance of default rights of a banking organization in case of a counterparty's receivership, conservatorship or resolution under Title II of the Dodd-Frank Act, the FDI Act, or similar insolvency law applicable to GSEs. The IFR expands the permissible stays or avoidances of default rights in a netting or collateral agreement to include a counterparty's receivership, conservatorship or resolution under the laws of foreign jurisdictions that are substantially similar to U.S. laws by the terms of such laws or by incorporation of such laws through agreement.

In determining whether the laws for a foreign jurisdiction are similar to Title II of the Dodd-Frank Act and the FDI Act and provide for limited stays "substantially similar" to those provided for in those laws, the Agencies intend to consider all aspects of stays under U.S. laws. Relevant factors according to the Agencies include the length of stay and the related creditor safeguards or protections provided under a foreign special resolution regime. The Agencies further state their expectation that the special resolution regimes of France, Germany, Japan, Switzerland, and the United Kingdom would be similar to those of the U.S. and provide for limited stays substantially similar to those under Title II of the Dodd-Frank Act and the FDI Act. The IFR does not state how or when the Agencies intend to make this "expectation" a finding that would satisfy the definitions, but presumably this would be done by order or other guidance. The IFR also does not provide for a process by which counterparties may request that the Agencies make a similarity determination with respect to other jurisdictions.

The Agencies also announced their intention to incorporate the IFR's revised definition of QMNA into the rules establishing margin requirements for uncleared swaps for registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants ("covered swap entities") subject to the Agencies' supervision.[15] As proposed by the Board, the OCC, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency, these rules would permit covered swap entities to calculate variation margin requirements on an aggregate, net basis under an "eligible master netting agreement" with a counterparty. The Agencies state their intention to align the definition of "eligible master netting agreement" with that of QMNA.

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[15] *See* Margin and Capital Requirements for Covered Swap Entities; Proposed Rule, 79 Fed. Reg. 57347 (Sept. 24, 2014). The Commodity Futures Trading Commission has also proposed rules in this regard, *see* 79 Fed. Reg. 59897 (Oct. 3, 2014).

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