Client Update

Amendments to U.S. Bank Capital and Other Rules to Address the Global Implementation of Special Resolution Regimes for Banks

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On December 16, 2014, the Office of Comptroller of the Currency of the U.S. Treasury Department (the "OCC") and the Board of Governors of the Federal Reserve System (the "FRB" and, together with the OCC, the "Agencies") issued an interim final rule (the "Interim Final Rule")[1] amending the definition of "qualifying master netting agreement" ("QMNA") under the Agencies' regulatory capital rules (the "Capital Rules")[2] and liquidity coverage ratio rule (the "LCR Rule"),[3] as well as the OCC's lending limits rule applicable to national banks and federal savings associations (the "Lending Limits Rules").[4] The Interim Final Rule also amends the definitions of "collateral agreement," "eligible margin loan" and "repo-style transaction" under the Capital Rules. These 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 the

[1] The text of the Interim Final Rule is available at: http://www.federalreserve.gov/newsevents/press/bcreg/20141216a.htm

[2] OCC and FRB, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule," 78 Fed. Reg. 62018 (Oct. 11, 2013), available at: http://www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm

[3] OCC, FRB and Federal Deposit Insurance Corporation ("FDIC"), "Liquidity Coverage Ratio: Liquidity Risk Management Standards," 79 Fed. Reg. 61440 (Oct. 10, 2014), available at: http://www.federalreserve.gov/newsevents/press/bcreg/20140903a.htm

[4] OCC Interim Final Rule, "Lending Limits," 78 Fed. Reg. 37265 (June 21, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-06-21/pdf/2012-15004.pdf
See also OCC Final Rule, "Lending Limits," 78 Fed. Reg. 37930 (June 25, 2013), available at: http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-17.html

implementation of special resolution regimes in foreign jurisdictions or by the ISDA 2014 Resolution Stay Protocol[5] (the "ISDA Stay Protocol") published by the International Swaps and Derivatives Association ("ISDA").

The Interim Final Rule, which applies to banking organizations other than state nonmember banks, will be effective as of January 1, 2015. Comments are due by March 3, 2015.

BACKGROUND

Benefits of a QMNA and Collateral Agreement

The Capital Rules permit a bank to measure exposure from certain types of financial contracts on a net basis and to recognize the risk-mitigating effect of financial collateral[6] for certain exposures if the contracts are subject to a QMNA.

For example, under the Capital Rules, a bank with multiple over-the-counter ("OTC") derivatives that are subject to a QMNA with a counterparty is permitted to calculate a credit risk exposure to the counterparty by giving effect to netting under the QMNA for purposes of calculating the risk-weighted asset amount. In addition, where those contracts are collateralized by a collateral agreement, the exposure amount will be reduced to reflect the counterparty credit risk mitigation of collateral in accordance with a method prescribed under the Capital Rules.

For purposes of the supplementary leverage ratio[7] (as applied only to advanced approaches banking organizations), a bank with multiple OTC derivatives with

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[5] The ISDA 2014 Resolution Stay Protocol can be downloaded from: http://www2.isda.org/functional-areas/protocol-management/protocol/20

[6] Generally, under the Capital Rules, "financial collateral" means collateral in the form of (1) cash on deposit with the banking organization (including cash held for the banking organization by a third-party custodian or trustee); (2) gold bullion; (3) long-term debt securities that are not resecuritization exposures and that are investment grade; (4) short-term debt instruments that are not resecuritization exposures and that are investment grade; (5) equity securities that are publicly traded; (6) convertible bonds that are publicly traded; or (7) money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily. In addition, the Capital Rules require that the banking organization have a perfected, first-priority security interest or, outside of the U.S., the legal equivalent thereof (with the exception of cash on deposit and notwithstanding the prior security interest of the custodial agent).

[7] See section 10(a)(5) and (c)(4) of the Capital Rules, 78 Fed. Reg. at 62170-62171. See also OCC, FRB and FDIC, "Regulatory Capital Rules: Regulatory Capital, Revisions to Supplementary Leverage Ratio," 79 Fed. Reg. 57725 (Sep. 26, 2014), available at: http://www.federalreserve.gov/newsevents/press/bcreg/20140903b.htm

the same counterparty that are subject to a QMNA would be permitted to net for purposes of calculating the counterparty credit risk component of its total leverage ratio. Additionally, if certain conditions are met (including the condition that cash collateral and derivatives are subject to a QMNA), such bank may exclude from its total leverage exposure cash variation margin received from such counterparty that has offset the positive mark-to-fair value of the derivative asset, or cash collateral posted to such counterparty that has reduced the bank's on-balance sheet assets.

Under the LCR Rule, for derivative transactions subject to a QMNA, a banking organization may calculate the net derivative outflow or inflow amount by netting the contractual payments and collateral that it would give to, or receive from, the counterparty over a 30-day period, resulting in a lower LCR denominator and liquidity requirement than if a bank were to calculate its inflows and outflows on a gross basis (as would be required in the absence of a QMNA).

Under the Lending Limits Rules, for derivative transactions subject to a QMNA, national banks and federal and state-charted savings associations using an internal model to calculate their counterparty credit exposure on derivatives transactions may calculate such exposure on a net basis for derivatives subject to a QMNA. The Lending Limits Rules also permit banks and savings associations to calculate their counterparty credit exposures on derivatives transactions using either of two non-internal model methods, one of which (*i.e.*, the current exposure method) follows the same method for determining the counterparty credit exposure amount of multiple OTC derivatives under the Capital Rules, which, as noted above, is calculated by giving effect to the netting for derivatives subject to a QMNA.

With respect to eligible margin loans and repo-style transactions, the Capital Rules and Lending Limits Rules similarly confer benefits on banks if such transactions with a counterparty are subject to a QMNA.[8]

[8] For regulatory capital purposes, a bank may calculate the exposure amount of a single-product netting set of eligible margin loans or repo-style transactions on a net basis if the relevant transactions are subject to a QMNA, and may recognize the risk-mitigating effect of financial collateral used to reduce its exposures relating to such transactions if the collateral is subject to a collateral agreement and certain other conditions are met. For purposes of the supplementary leverage ratio, an advanced approaches banking organization with multiple repo-style transactions with the same counterparty is permitted, under generally accepted accounting principles ("GAAP"), to offset the gross values of receivables due from a counterparty under such transactions by the amount of the payments due to the same counterparty, provided the relevant accounting criteria are met (the "GAAP offset"), but must reverse the GAAP offset for purposes of calculating its total leverage exposure

Current Definitions

Generally, to qualify as a QMNA, a netting agreement must provide a bank the right to accelerate, terminate and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default (such right to accelerate, terminate, close out and set off, collectively, the "early termination rights"), including in the event of the receivership, conservatorship, insolvency, liquidation, or similar proceeding of the counterparty, and thereby creates a single obligation for all transactions governed by such netting agreement upon the occurrence of the event of default, as long as in any such case, any exercise of the early termination rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions.

Similarly, in general, to qualify as an "eligible margin loan" or a "repo-style transaction," a margin loan (for eligible margin loans) or a repurchase, reverse repurchase or securities lending transaction (for repo-style transactions),[9] as applicable, must be conducted under an agreement that provides the bank with similar early termination rights as are required for a QMNA, and the exercise of such rights must not be stayed or avoided under applicable law in the relevant jurisdictions.

Finally, in general, to qualify as a "collateral agreement," a contract must give a bank a first-priority security interest (or legal equivalent) in the collateral posted by its counterparty and must provide the bank similar early termination rights as those required for a QMNA, eligible margin loan or repo-style transaction, and the exercise of such rights must not be stayed or avoided under applicable law in the relevant jurisdictions.

The current definitions of QMNA, eligible margin loan, repo-style transaction and collateral agreement each recognizes that the early termination rights may be stayed or avoided if the counterparty is a financial company that is in

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unless the transactions are subject to a QMNA and certain other conditions relating to the cash collateral are met. In other words, absent a QMNA covering the repo-style transactions, the bank must replace the net on-balance sheet assets of the transactions determined under GAAP with the gross value of receivables for such transactions for purposes of calculating its total leverage exposure.

[9] A repurchase, reverse repurchase or securities lending transaction may qualify as a repo-style transaction under the Capital Rules without being subject to such an agreement if the transaction is a "securities contract" or "repurchase agreement" under section 555 or 559, respectively, of the U.S. Bankruptcy Code, a qualified financial contract under the Federal Deposit Insurance Act or a netting contract between or among financial institutions under the Federal Deposit Insurance Corporation Improvement Act or the FRB's Regulation EE.

receivership, conservatorship or resolution under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Federal Deposit Insurance Act ("FDIA") or any similar insolvency law applicable to Government Sponsored Enterprises ("GSEs"). However, the current definitions do not recognize that certain early termination rights may be stayed or avoided where such early termination rights under a particular agreement are subject to a limited stay, or avoided, under foreign special resolution regimes ("SRRs") or where counterparties agree through contractual arrangements (such as the ISDA Stay Protocol) that an SRR (other than Title II of the Dodd-Frank Act or FDIA or similar insolvency law applicable to GSEs) will apply.[10]

Absent an amendment to the QMNA definition, a master netting agreement for which a bank's early termination rights may be stayed or avoided under foreign SRRs or under the terms of the agreement itself would no longer qualify as a QMNA under the Capital Rules, the LCR Rule or the Lending Limits Rules, resulting in considerably higher capital and liquidity requirements and requiring national banks and federal savings associations to measure their lending limits on a gross basis.

Similarly, absent an amendment to the definitions of 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 certain SRRs will apply or for which a bank's early termination rights may be stayed or avoided under foreign SRRs would not qualify as an eligible margin loan or repo-style transaction, as applicable, and the bank would not receive the netting and set-off benefits described above for such transactions.

Finally, for an agreement that provides a bank a first-priority security interest in its counterparty's collateral, absent an amendment to the definition of collateral agreement, if a bank's exercise of its early termination rights under such an agreement may be stayed or avoided under foreign SRRs or if the agreement provides that certain SRRs will apply, the agreement would not qualify as a collateral agreement and the bank would not receive the benefits described above.

EU's Bank Recovery and Resolution Directive and ISDA Stay Protocol

On April 15, 2014, the European Union ("EU") issued the Bank Recovery and Resolution Directive (the "BRRD"), which prescribes aspects of an SRR that EU

[10] When the Agencies adopted the current QMNA definition, no other country had adopted an SRR relevant to the definition, and banks had not yet decided to amend their ISDA Master Agreements to clarify that their OTC derivatives transactions are subject to certain U.S. and foreign SRRs.

member nations have to implement by December 31, 2014 in order to increase the likelihood for successful national or cross-border resolutions of a financial company organized in the EU. The BRRD is intended to be generally consistent with the "Key Attributes of Effective Resolution Regimes for Financial Institutions" that have been adopted by the Financial Stability Board ("FSB") of the G-20 nations and are designed to provide a standard for the responsibilities and powers that national resolution regimes should adopt to resolve a failing systemically important financial institution. Therefore, the BRRD contains special resolution powers, including a limited stay on certain financial contracts that is similar to the stays provided under FDIA and Title II of the Dodd-Frank Act. Most of the provisions of the BRRD are expected to take effect in a number of EU member nations on January 1, 2015. Therefore, the operations of U.S. banking organizations located in jurisdictions that have implemented the BRRD could become subject to an orderly resolution under the BRRD, including the application of a limited statutory stay of a counterparty's right to exercise early termination rights and other remedies with respect to certain financial contracts.

Furthermore, due to the international nature of many derivatives transactions and financial contracts, another important part is to ensure that a particular SSR is enforceable upon and recognized by a counterparty who would not otherwise be subject to the jurisdictional reach of that SSR (*e.g.*, a U.S. person who entered into a New York law-governed ISDA Master Agreement with a German bank, or a French person who entered into an English law-governed ISDA Master Agreement with a U.S. bank).

On November 4, 2014, ISDA published the ISDA Stay Protocol, which provides for the parties that have both adhered to such protocol to amend the terms of their ISDA Master Agreements and the related credit support agreements or arrangements by explicitly agreeing to subject themselves ("opt in") to certain eligible SSRs that stay and, in certain cases, override certain cross-default and direct-default rights otherwise included in derivatives contracts that could arise upon the entry of a bank, or certain of its affiliated entities, into receivership, insolvency, liquidation, resolution or similar proceedings. The ISDA Stay Protocol has two sections. Under Section 1, the adhering parties agree to opt in to the SSR applicable to their counterparty, and each "related entity"[11] of their counterparty, if the counterparty or related entity becomes subject to proceedings under certain SSRs. In other words, an adhering party agrees to limit its early termination rights and remedies to only those permitted under the SSR

[11] The related entities include "Credit Support Providers," "Specified Entities" (as such terms are used in an ISDA Master Agreement) and certain parent entities.

applicable to its counterparty (and related party) that is in resolution, including any stays and overrides on the exercise of direct defaults or cross-defaults. Currently, Section 1 of the ISDA Stay Protocol applies with respect to the SSRs in France, Germany, Japan, Switzerland, the United Kingdom and the U.S.; in the future, Section 1 may apply in other FSB jurisdictions if the SSR in those jurisdictions satisfy certain requirements set forth in the ISDA Stay Protocol.[12] Section 1 provisions will become effective between the initial adhering parties on January 1, 2015 (and between post-January 1, 2015 adhering parties, when such parties adhere to the ISDA Stay Protocol). Section 2 of the ISDA Stay Protocol is related to certain U.S. insolvency provisions that are expected to be implemented soon. U.S. regulators expect to introduce regulations in 2015 that will require counterparties of certain banking groups to limit certain cross-default and direct-default rights arising when an affiliate (including a parent) becomes subject to proceedings under U.S. insolvency regimes. Essentially, because the U.S. Bankruptcy Code and FDIA do not currently provide for a stay on the exercise of cross-default rights, the ISDA Stay Protocol must provide one contractually. The provisions of Section 2 are designed to mirror the regime of the Orderly Liquidation Authority under Title II of the Dodd-Frank Act. However, the Section 2 U.S. insolvency proceedings provisions of the ISDA Stay Protocol will become effective on the adhering parties only on the date the related U.S. regulations become effective and compliance therewith is required. Thus, the Interim Final Rule does not address Section 2 of the ISDA Stay Protocol as this portion is not effective on January 1, 2015.

As of today, a number of global financial institutions, including several of the largest U.S. banks, have adhered to the ISDA Stay Protocol and thereby have agreed to modify their ISDA Master Agreements entered into with other adhering parties in accordance with the terms of the ISDA Stay Protocol.

INTERIM FINAL RULE

In brief, the Interim Final Rule amends the definitions of "collateral agreement," "eligible margin loan," "qualifying master netting agreement" and "repo-style transaction" in the Capital Rules and "qualifying master netting agreement" in the LCR Rule. Specifically, the Interim Final Rule amends these definitions to allow a netting agreement or collateral agreement to provide that the exercise of

[12] The requirements include: a non-discrimination clause with respect to creditors, the length of the temporary stay shall not be longer than two business days, satisfaction of certain payment and delivery obligations during such stay, protection of all netting and set-off rights under the applicable agreements, and the party in resolution (or its transferee) shall remain obligated under the applicable agreements to the same extent it was obligated prior to the exercise of authority under the SSR.

early termination rights under such agreement may be stayed or avoided under Title II of the Dodd-Frank Act, FDIA, or any similar insolvency law applicable to GSEs, or under a similar foreign SRR by the application of such SRR, or under a foreign SRR incorporated by agreement between the parties such as the ISDA Stay Protocol. These amendments are designed to ensure that a bank may continue to recognize the determination of various measures of exposure and limits on a net basis and the risk mitigating effects of financial collateral received in a derivatives transaction, repo-style transaction or eligible margin loan for purposes of the Capital Rules, LCR Rule and Lending Limits Rules, while recognizing the recent changes contemplated by BRRD and the ISDA Stay Protocol.

As discussed earlier, without the amendments set forth in the Interim Final Rule, the definitions would only permit limitations to, or avoidance of, the exercise of early termination rights of a bank in case of a counterparty's receivership, conservatorship or resolution under FDIA, Title II of the Dodd-Frank Act, or any similar insolvency law applicable to GSEs. The Interim Final Rule expands the types of permissible limitations and avoidance of early termination rights in a netting or collateral agreement to include early termination rights to be stayed or avoided upon a receivership, conservatorship or resolution under laws of foreign jurisdictions that are substantially similar to the foregoing U.S. laws in order to facilitate the orderly resolution of the defaulting counterparty by the terms of such law or by incorporation of such foreign laws through agreement.

The Agencies note that in determining whether the laws of foreign jurisdictions are "similar" to FDIA and Title II of the Dodd-Frank Act, the Agencies intend to consider all aspects of the stays under the U.S. laws. Relevant factors include, for instance, the length of stay and the related creditor safeguards or protections provided under a foreign SRR. We note that the Agencies did not provide for any procedure by which either the Agencies or the interested banks can initiate or request such a determination. The Agencies also note that they expect the implementation of SRRs of France, Germany, Japan, Switzerland and the United Kingdom to be substantially similar to those of the U.S. and provide for limited stays substantially similar to those provided for in FDIA and Title II of the Dodd-Frank Act.

Last, the Agencies state that they intend to incorporate the Interim Final Rule's revised QMNA definition into rules establishing minimum margin requirements for registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants ("covered swap entities") subject to agency supervision. As currently proposed, the margin rules permit a covered swap entity to calculate variation margin requirements on an aggregate, net basis,

under an "eligible master netting agreement" with a counterparty; the Agencies state that they intend to align the definition of "eligible master netting agreement" with the new QMNA definition.

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Please feel free to contact us with any questions.