STATEMENT OF
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ON
THE REGULATION OF FINANCIAL DERIVATIVES
AND THE FINANCIAL DERIVATIVES MARKET
COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
10:00 A.M.
JULY 24, 1998
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Chairman Leach, Ranking Member LaFalce, and members of the Committee, the Federal Deposit Insurance Corporation appreciates the opportunity to present its views on the regulation of financial derivatives and the financial derivatives market and on legislation to revise insolvency laws relating to financial derivatives. We would particularly like to thank you, Mr. Chairman, for introducing H.R. 4239, the Financial Contract Netting Improvement Act of 1998, and for holding the hearing today to consider this important legislation. We would also like to thank Ranking Member LaFalce, Vice Chairman McCollum, and Financial Institutions Subcommittee Chairwoman Roukema for co-sponsoring H.R. 4239.

Banks and corporations use over the counter (OTC) derivative contracts to shape earnings, market, liquidity and credit risk profiles. Some banks use these contracts strictly as end-users to manage their internal risk profiles, while other dealer banks are net providers of these contracts. Dealer banks provide these contracts both to end-user banks and to end-user corporate clients and, thus, are important links in the chain of providing financial intermediation services. These banks match end-users with offsetting risk profiles. They also enter into contracts with end users that shift these risks directly to them. Dealer banks have a broader array of markets to distribute these exposures and greater technical expertise to effectively manage these risks on a global basis than do most end-users.

As of March 31, 1998, the notional amount of derivatives in commercial bank portfolios was $26 trillion, of which 85 percent was from OTC transactions. About 70 percent of the $26 trillion was in interest rate transactions. Eight banks accounted for the vast majority of bank derivative activity.

The benefits of OTC contracts to the world economy include less concentrated risk in end-user banks and end-user corporations. By entering into these contracts, the end-user is afforded the opportunity to secure more stable earnings, for example, when interest rates change dramatically. Many end-users would be less successful in managing their exchange rate and interest rate volatility exposures if the OTC market were unavailable. OTC contracts allow end-users to concentrate expertise in the core business lines that are most familiar to them with only a small diversion of resources to understand and manage the risks of the contracts.

The FDIC insures banks and thrifts that are both dealers and end-users of OTC contracts. However, the banks that we supervise are primarily end-users of these contracts. The FDIC places great emphasis on the safe and sound use and provision of these contracts by insured banks. We work closely with the Office of the Comptroller of the Currency and the Federal Reserve Board, the primary supervisory agencies of dealer banks, to assure that dealer banks are adequately identifying, monitoring, measuring and controlling the risks associated with this activity.

In your letter of invitation you requested that we comment on recent regulatory events that may have adversely affected OTC derivatives markets. The market for OTC contracts has grown and evolved significantly over the last few years. Mr. Chairman, your legislation seeks to preserve the health and continued evolution of this important financial marketplace. This is an important goal. The Commodity Futures Trading Commission, in its Concept Release, has raised a number of important issues about this market, which has led to concerns by some market participants and regulatory authorities about international competitiveness and legal uncertainties. Given the importance of OTC contracts for risk management and the large size of the market, examination and careful study of the issues surrounding the functioning of the OTC market and its regulation is advisable.

The CFTC's actions, which have heightened these concerns on the part of some, have nonetheless served to point out the pressing need for comprehensive study of the appropriate level and character of regulation of these markets. This effort should include the expertise of several different sectors, including the CFTC, the SEC, the banking regulatory agencies and others. The existing Working Group on Financial Markets could serve as an appropriate vehicle for the conduct of this study. Whatever the vehicle, however, we support the prompt commencement of a multi-party study.

The rest of my testimony will focus on H.R. 4239, which adopts proposals of the President's Working Group on Financial Markets. The FDIC participated on the Working Group and assisted in drafting the group's proposals. We support H.R. 4239. Attached to our testimony is a brief summary of the bill's background, proposals and effects.

H.R. 4239 will result in more consistent and predictable treatment of derivatives. Enactment of the legislation will clarify the rights of the parties to a derivative contract and the treatment of those contracts if a party becomes insolvent. As a result, market participants will have a better understanding of their rights and will be able to more accurately assess and manage the risks arising from derivative contracts. The legislation will also clarify the FDIC's right, as the receiver for failed banks and thrifts, to transfer qualified financial contracts (QFCs). It will, in addition, expand the number of potential transferees.

As I have discussed, through swaps and other types of derivative contracts, depository institutions can manage their interest rate and other risks. Nonetheless, these advantages do not come without risks. One of the primary risks is the potential market disruption, and contractual uncertainty created by the insolvency of one of the parties to a derivative or other financial contract.

The Federal Deposit Insurance Act (the FDI Act) defines QFCs as consisting primarily of financial derivatives and similar instruments. Both, the FDI Act and the Bankruptcy Code grant special treatment to QFCs in insolvency proceedings. The FDI Act and the Bankruptcy Code grant those who have entered into financial derivative contracts with parties that subsequently become insolvent greater rights than these statutes grant those who enter into most contracts. In the case of a derivative contract, a market participant has greater rights to terminate the contract and to net, dollar for dollar, its obligations to the insolvent against the insolvent's debts to the counterparty. The statutes are, of course, much more intricate than this brief description. Unfortunately, the statutes also are not entirely consistent in their treatment of similar contracts. Without modification, current statutes governing netting will not adequately address market innovations. In addition, current statutes are not always clear about which contracts are entitled to special protection or about the flexibility of a receiver or trustee in dealing with QFCs.

Consistency, predictability and enhanced protection in the case of insolvency are extremely important in the derivatives market. Absent these conditions, market participants will be more likely to take precipitous action to protect their interests if a counterparty exhibits financial weakness, potentially impairing the efficient functioning of the capital markets. More important, consistency, predictability and enhanced protection can reduce the systemic risk to financial systems that an insolvency can pose, given the enormous volume of derivative contracts and the interdependence of market participants. The ability to terminate or transfer QFCs is extremely important to the receiver of an insolvent bank or thrift. QFCs can be valuable assets and significant liabilities. While parties to QFCs receive - and should receive - additional protection under insolvency laws, a bank or thrift receiver must have a clear right to terminate or transfer QFCs, and flexibility in transferring them. Granting a receiver these rights allows it to determine the most appropriate resolution for a failed institution and to maximize the recovery for depositors, the deposit insurance funds, and other creditors. Granting these rights also reduces systemic risk by permitting transfer, rather than forcing termination, of QFCs.

H.R. 4239 makes the following important statutory improvements. The bill:

Expands and clarifies the definitions of QFCs;
Makes the Bankruptcy Code and the bank insolvency provisions of the FDI Act more consistent in their treatment of similar contracts;
Revises and clarifies the definitions of the types of QFCs that benefit from netting in line with market innovations and practices and clarifies that parties to master netting

agreements may agree to net obligations owed on different kinds of QFCs, such as swaps, commodity contracts, and repurchase agreements;
Clarifies the notice and timing rights of the FDIC as receiver to transfer or repudiate any QFC; and
Expands the flexibility of the FDIC as receiver in transferring QFCs held by a failed insured depository institution to other market participants.
In closing, let me reiterate the FDIC's support for H.R. 4239. Passage of the bill will benefit the market, market participants and the creditors of failed banks and thrifts. It will fix a problem before it arises. Mr. Chairman, I would be happy to answer any questions you may have at this time.

Summary of the Background, Proposals and Effects of H.R. 4239
The Financial Contract Netting Improvement Act of 1998

I. Current Statutory Background

Current statutory provisions governing derivative and related financial contracts upon the insolvency of a counterparty may be found primarily in the FDI Act, FDICIA, the Bankruptcy Code, and the Securities Investor Protection Act of 1971. These provisions contain significant variations in the definitions of the contracts to which they are applicable and in the potential treatment of counterparties. Perhaps most important is the ambiguity and uncertainty created by possible overlap and inconsistencies between the statutory schemes. One of the primary goals of the Working Group has been to enhance predictability for market participants by clarifying the definitions and substantive provisions of these statutes.

The Bankruptcy Code governs insolvency proceedings for most corporations, while the Securities Investor Protection Act of 1971 governs insolvency proceedings involving stockbrokers who are members of the Securities Investor Protection Corporation. Insolvencies of insured depository institutions are not governed by the Bankruptcy Code, but by the bank receivership provisions of the FDI Act and the National Bank Act. FDICIA also includes provisions that govern the treatment of netting contracts between financial institutions.

The FDI Act defines certain contracts as "qualified financial contracts." Under the FDI Act, QFCs are defined by reference to statutory definitions for five types of contracts: securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements. Upon appointment of the FDIC as receiver for an insured depository institution, QFC counterparties receive certain benefits and rights which are not available to parties to other types of contracts. First, any repudiation or transfer of the QFC by the receiver must occur by 12:00 noon local time on the business day following the appointment of the receiver.1 Second, if the receiver does not provide notice of the repudiation or transfer of the QFC by close of business (New York time) on the business day following appointment of the receiver, the QFC counterparty can exercise contractual rights to terminate the QFC and offset or net out any termination values, payment amounts, or other transfer obligations under the agreement which arise upon appointment of a conservator or receiver.2 Third, the receiver or conservator cannot avoid any transfer of money or other property made in connection with the QFC, unless the recipient had actual intent to hinder, delay or defraud the institution, the creditors of the institution or any receiver or conservator of the institution.3 Fourth, if the receiver is to transfer any QFCs to a third party, the receiver must transfer all QFCs with the same counterparty (including its affiliates) to a single depository institution. Finally, if the receiver repudiates a QFC, the counterparty may recover damages incurred up to the date of the repudiation (rather than to the date of appointment of the receiver as with most other agreements under FIRREA), and the recoverable damages may include reasonable costs of cover or other reasonable measures of damages used in the industry.4

Sections 402 through 404 of FDICIA, 12 U.S.C. __ 4402-4404, provide a significant expansion in the statutory protection afforded to contractual netting. Unlike the FDI Act provisions, these protections are not limited to QFCs. FDICIA confirms the enforceability of the netting of payment obligations among "financial institutions" under a "netting contract." The breadth of the FDICIA netting provisions is underscored by the terms of sections 4403 and 4404, which protect netting "[n]otwithstanding any other provision of law." The key to the scope of this protection is the definition of "netting contract." Netting contract is defined, in pertinent part, to mean: "... a contract or agreement between [two] ... financial institutions that ... is governed by the laws of the United States, any State, or any political subdivision of any State, and ... provides for netting present or future payment obligations or payment entitlements (including liquidation or close-out values relating to the obligations or entitlements) ... [between] the parties to the agreement ...." Some have argued that the FDICIA netting provisions permit close-out netting of such contracts irrespective of the FDIC's rights as receiver under the FDI Act. The FDIC believes that FDICIA and the FDI Act must be interpreted in harmony to permit the FDIC to enforce agreements under section 1821(e)(12) unless the agreements are QFCs under section 1821(e)(8).

II. PROVISIONS OF H.R. 4239

A. Overview of Proposed QFC Amendments

The portions of H.R. 4239 that amend the treatment of QFCs address several significant issues for bank receiverships, while providing additional clarification and consistency that reduces systemic risk in all insolvencies. The key issues addressed in the QFC amendments are as follows:

Expansion and clarification of the definitions of the component contracts included as QFCs under section 11(e)(8)(D)(I) of the FDI Act, 12 U.S.C. _ 1821(e)(8)(D)(I). These changes accommodate changes in the marketplace.
Clarification of the relationship between the FDI Act's QFC provisions and FDICIA's netting provisions. The proposal confirms that the FDIC as receiver retains the right to transfer or repudiate any QFCs irrespective of the FDICIA netting provisions and clarifies the notice and timing requirements for such transfers and repudiations.

Although the FDIC believes that it has such rights under the FDI Act and FDICIA, some ambiguity had been created by the original provisions of FDICIA. See 12 U.S.C. _ 4403(a) ("Notwithstanding any other provision of law . . ."). The QFC Amendments would confirm that the FDIC retains its powers under the FDI Act.
Expansion of potential transferees of QFCs to include financial institutions (rather than the current statutory limitation to depository institutions), bridge banks and conservatorships. These provisions also confer upon the FDIC the regulatory flexibility to expand the definition of "financial institution."
In addition, the QFC Amendments will provide the FDIC with some flexibility in transferring QFCs to foreign banks and in transferring QFCs subject to the rules of a clearing house. Under the proposal, the FDIC can transfer QFCs to a foreign bank or to the branch or agency of a foreign bank if the contractual rights of the parties to those QFCs are enforceable "substantially to the same extent" as under the FDI Act after the transfer. The FDIC also would be able to transfer QFCs subject to clearing house rules to non-clearing house members, but the transfer would not require the clearing house to accept the transferee as a member.

Inclusion of provisions to clarify that cross-product netting is permitted under the FDI Act and the Bankruptcy Code. These provisions would permit parties to appropriate master netting agreements to contractually determine a single net amount due from one party across a variety of QFCs, such as swaps, commodity contracts, and repurchase agreements. This change furthers the FDIC's policy of promoting the enforceability of appropriate netting agreements in order to reduce risk to counterparties.
B. Definitions

Component Agreements
H.R. 4239 includes significant revisions to the definitions of qualified financial contract, securities contract, commodity contract, forward contract, repurchase agreement, and swap agreement.

One of the principal goals of the proposed revisions of the statutory definitions is to provide consistent definitions in the FDI Act and in the Bankruptcy Code. This will promote consistent treatment of derivative contracts under the insolvency laws governing banks and most other entities. A significant difference between the FDI Act and Bankruptcy Code definitions will be to confer the authority in the FDI Act on the FDIC's Board to expand the definition of "qualified financial contract" by regulation, resolution or order.

The definitions for repurchase agreement and swap agreement have been revised to include agreements for the transfer of "qualified foreign government securities." This removes the prior limitation of the definition to those agreements involving "direct obligations of, or that are fully guaranteed . . . by, the United States or any agency of the United States." H.R. 4239 includes a definition for "qualified foreign government securities" cross-referencing the provisions of any applicable "regulation or order adopted by the appropriate federal banking authority." The proposed Bankruptcy Code definition of "repurchase agreement" includes a parallel definition of "qualified foreign government securities."

The proposed definition of "swap agreement" includes "spot, same day-tomorrow, tomorrow-next, forward or other foreign exchange agreement." This provision also rearranges the definition by ordering the references to swap transactions in a sequence of related types of swaps, options, futures, and forwards, such as interest rate transactions and credit transactions.

Credit Enhancement

The definitions also expand QFC treatment to "credit enhancements" related to one of the defined QFC component contracts. The banking agencies, including the FDIC, OCC, and Federal Reserve System, have adopted risk-based capital standards based on the revisions to the Basle Accord that recognize the reductions in credit risk exposures in derivative transactions resulting from qualifying bilateral netting arrangements. Although those standards focus on qualifying collateral arrangements, and not "credit enhancements", it may be appropriate in a liquidation context to recognize broadly the credit risk reductions achieved through non-collateral arrangements. The FDI Act currently recognizes rights under "security arrangements" as part of the QFC rights protected under section 11(e)(8)(A) and (D). The inclusion of a broad recognition of legally enforceable "credit enhancements" as protected parts of the QFC in our statutory insolvency provisions may serve to encourage the use of these risk reduction techniques to the benefit of the marketplace and banking community.

C. Clarification of the Relationship between the FDI Act and FDICIA

H.R. 4239 confirms that the FDICIA netting provisions do not impair the FDIC's powers to repudiate or transfer any QFC. The proposal confirms that "no provision of law" can be construed to limit those powers. While this has always been the FDIC's interpretation, the FDICIA language: "Notwithstanding any other provision of law," 12 U.S.C. __ 4403, 4404, has created some ambiguity.

H.R. 4239 also confirms that a QFC counterparty cannot exercise its rights under section 11(e)(8)(A) to terminate, liquidate or net out until after 5:00 p.m. on the business day following appointment of the receiver. This provision confirms that the FDIC has a one-day "window" to decide whether to transfer or repudiate the counterparty's QFCs. Similarly, the proposal includes a provision confirming that rights to terminate, liquidate or net out cannot be exercised solely due to appointment of a conservator.

D. Expansion of Potential Transferees of QFCs

H.R. 4239 expands the potential transferees of QFCs after the FDIC is appointed receiver in two significant ways. First, the proposal eliminates the current limitation of transfer to "depository institutions" and permits transfers to "financial institutions." The term "financial institution" is defined in the proposal to include brokers, dealers, future commission merchants or other institutions determined by the FDIC by regulation, resolution, or order. This definition is consistent with FDICIA, although the proposed FDI Act amendment would confer upon the FDIC the regulatory flexibility to expand the definition of "financial institution." Under FDICIA, that flexibility is given solely to the Board of Governors of the Federal Reserve System. 12 U.S.C. _ 4402(9). Second, H.R. 4239 includes provisions ensuring that the FDIC may transfer QFCs to a bridge bank or an institution in conservatorship. Although the proposal precludes transfers to financial institutions for which a conservator, receiver, trustee or other custodian has been appointed, this is designed to prevent transfers to other insolvent entities or to non-bridge bank receiverships. Bridge banks and institutions in conservatorships are separately exempted from that limitation.

E. Provisions Permitting Cross-Product Netting

H.R. 4239 expands the coverage of the current definition of "master agreement" beyond swap agreements to encompass all QFCs. A conforming provision is included in the Bankruptcy Code revisions as well. These changes will authorize cross-product close-out netting under the FDI Act and the Bankruptcy Code by treating all QFCs subject to a master agreement as a single QFC. Consequently, the counterparty will be able to terminate, liquidate, or net out all QFCs as a unit and gain the maximum credit risk benefits from the master netting agreement. Current FDI Act provisions do not draw distinctions between types of QFCs in authorizing close-out netting of individual QFCs under section 11(e)(8)(A). The FDI Act's authorization for netting of "1 or more contracts and agreements" defined as QFCs already permits cross-product netting. This change simply permits bilateral netting of all QFCs between a single counterparty and its affiliates and the failed depository institution. This encouragement of cross-product netting is consistent with the FDIC's risk-based capital standards for derivatives.

The provision, however, does not provide QFC treatment to non-QFC agreements simply because they might be covered by the master agreement. If the master agreement includes such non-QFC agreements, then the master agreement receives QFC treatment only for those agreements that would otherwise be QFCs. This limitation will prevent bundling of non-QFC agreements under a master agreement in order to provide special QFC treatment to those agreements.

1 12 U.S.C. _ 1821(e)(9), (10). On December 12, 1989, the FDIC issued a Policy Statement on QFCs. Under the Policy Statement, the statutory provisions were clarified to require the receiver to notify the QFC counterparty of transfer by 12:00 noon local time on the business day after appointment of the receiver using best efforts. Section 11(e)(10) only requires notice as late as the business day following the transfer. The Policy Statement also clarified that a counterparty may not exercise its rights under section 11(e)(8)(A) of the FDI Act until the close of business (New York time) on the business day following appointment of the receiver. In addition, the Policy Statement clarifies that the receiver's efforts to notify the counterparty are sufficient if the receiver has "taken steps reasonably calculated to provide notice."

2 For non-QFC contracts, the FDIC has the statutory right to enforce the contracts "notwithstanding any provision of the contract providing for termination, default, acceleration, or exercise of rights upon, or solely by reason of, insolvency or the appointment of a conservator or receiver." 12 U.S.C. _ 1821(e)(12)(A).

3 12 U.S.C. _ 1821(e)(8)©(i), (ii). For QFCs, this section specifically overrides 12 U.S.C. _ 1821(e)(11), which gives the receiver the right to avoid a security interest taken in contemplation of insolvency or with intent to hinder, delay or defraud the institution or the creditors of the institution.

4 12 U.S.C. _ 1821(e)(3)(A)(ii)(II) and (C).

Last Updated 06/25/1999