FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429
Division of Supervision

Risk-Based Capital

FIL-6-95
January 10, 1995

TO: CHIEF EXECUTIVE OFFICER

SUBJECT: *Final Rule on the Recognition of Bilateral Netting Agreements*

The FDIC Board of Directors on December 20, 1994, approved a final rule amending risk-based capital standards to recognize the effect of bilateral netting agreements in reducing the credit risk of two types of financial derivatives -- interest and exchange rate contracts ("rate contracts"). This amendment represents a change in the way the current exposure portion of the credit equivalent amount for rate contracts is calculated. The Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision have issued similar rules for the institutions they supervise. A copy of the FDIC's final rule is attached.

Under the new rule, banks will be allowed to net positive and negative mark-to-market values of rate contracts with the same counterparty when calculating risk-based capital requirements, subject to legally enforceable bilateral netting contracts that meet certain criteria. The previous risk-based capital standard recognized only a very limited form of netting, referred to as "netting by novation." Also under the new rule, banks will be required to maintain documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions. The final rule allows for the complexity of the legal opinions to vary according to the extent and nature of the bank's involvement in rate contracts.

The rule went into effect when it was published in the *Federal Register* on December 28, 1994. An institution intending to use this risk-based capital treatment may apply the rule to the Reports of Condition and Income (Call Reports) beginning with the period ending December 31, 1994. An institution that chooses not to conform to the documentation requirements or otherwise not use this treatment for eligible rate contracts must follow the previous regulation to calculate risk-based capital requirements.

If a bank chooses to apply the final rule on bilateral netting when preparing the Call Reports for December 31, 1994, it should complete the risk-based capital schedule in the following manner. The replacement cost of interest rate and foreign exchange rate contracts (Schedule RC-R, Memorandum items 1.a and 1.b, column B) should continue to be reported using the previous instructions (that is, without netting contracts subject to bilateral netting agreements). However, when determining the credit equivalent amounts of these two types of contracts and reporting these amounts by risk-weight category (Schedule RC-R, items 4 through 7, column B), legally enforceable bilateral netting agreements that meet the criteria in the final rule should be recognized. Questions about these amendments to the Call Reports should be directed to Robert F. Storch, Chief of the Division of Supervision's Accounting Section (202-898-8906).

For more information or questions regarding the final rule, contact one of the FDIC officials listed on Page 66656 of the attached *Federal Register* notice.

Stanley J. Poling
Director

Attachment: Federal Register

Distribution: FDIC-Supervised Banks (Commercial and Savings)