[Federal Register: December 28, 1994]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 325

RIN 3064-AB42

Risk-Based Capital Standards; Bilateral Netting Requirements

AGENCY: Federal Deposit Insurance Corporation (FDIC or Corporation).

ACTION: Final rule.

SUMMARY: The FDIC is amending its risk-based capital standards to recognize the risk-reducing benefits of qualifying bilateral netting contracts. This final rule implements a recent revision to the Basle Accord permitting the recognition of such netting arrangements. The effect of the final rule is that state nonmember banks (banks) may net positive and negative mark-to-market values of interest and exchange rate contracts in determining the current exposure portion of the credit equivalent amount of such contracts to be included in risk-weighted assets.

EFFECTIVE DATE: December 28, 1994.

FOR FURTHER INFORMATION CONTACT: William A. Stark, Assistant Director, (202/898-6972), Curtis Wong, Capital Markets Specialist, (202/898-7327), Division of Supervision, FDIC, 550 17th Street, N.W., Washington, D.C. 20429; Jeffrey M. Kopchik, Counsel, (202/898-3872), Christopher Curtis, Senior Counsel, (202/898-3728), FDIC, Legal Division, 550 17th Street, N.W., Washington, D.C., 20429; Linda L. Stamp, Counsel, (202/736-0161), Legal Division, 1717 H Street, N.W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION:

Background

The Basle Accord[1] established a risk-based capital framework

which was implemented in the United States by the FDIC in 1989. Under this framework, off-balance-sheet interest rate and exchange rate contracts (rate contracts) are incorporated into risk weighted assets by converting each contract into a credit equivalent amount. This amount is then assigned to the appropriate credit risk category according to the identity of the obligor or counterparty or, if relevant, the guarantor or the nature of the collateral. The credit equivalent amount of an interest or exchange rate contract can be assigned to a maximum credit risk category of 50 percent.

\1\The Basle Accord is a risk-based framework that was proposed by the Basle Committee on Banking Supervision (Basle Supervisors' Committee) and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Basle Supervisors' Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

The credit equivalent amount of a rate contract is determined by adding together the current replacement cost (current exposure) and an estimate of the possible increase in future replacement cost in view of the volatility of the current exposure over the remaining life of the contract (potential future exposure, also referred to as the add-on).[2]

\2\This method of determining credit equivalent amounts for rate contracts is identified in the Basle Accord as the current exposure method, which is used by most international banks.

For risk-based capital purposes, a rate contract with a positive mark-to-market value has a current exposure equal to that market value. If the mark-to-market value of a rate contract is zero or negative, then there is no replacement cost associated with the contract and the current exposure is zero. The original Basle Accord and FDIC standards provided that current exposure would be determined individually for each rate contract entered into by a bank; banks generally were not permitted to offset, that is, net, positive and negative market values of multiple rate contracts with a single counterparty to determine one current credit exposure relative to that counterparty.[3]

\3\It was noted in the Accord that the legal enforceability of certain netting arrangements was unclear in some jurisdictions. However, the legal status of netting by novation was determined to be settled and this limited type of netting was recognized. Netting by novation is accomplished under a written bilateral contract providing that any obligation to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date. The previously existing contracts are extinguished and a new contract, for the single net amount, is legally substituted for the amalgamated gross obligations.

In April 1993 the Basle Supervisors' Committee proposed a revision to the Basle Accord, endorsed by the G-10 Governors in July 1994, that permits banks to net positive and negative market values of rate contracts subject to a qualifying, legally enforceable, bilateral netting arrangement. Under the revision, banks with qualifying netting arrangements are permitted to calculate a single net current exposure for purposes of determining the credit equivalent amount for the included contracts.[4] If the net market value of the contracts included in such a netting arrangement is positive, then that market value equals the current exposure for the netting contract. If the net market value is zero or negative, then the current exposure is zero.

\4\The revision to the Accord notes that national supervisors must be satisfied about the legal enforceability of a netting arrangement under the laws of each jurisdiction relevant to the arrangement. The Accord continues, if any supervisor is dissatisfied about enforceability under its laws, the netting arrangement does not satisfy this condition and neither counterparty may obtain supervisory benefit.

The FDIC's Proposal

On May 20, 1994, the Board of Governors of the Federal Reserve System (Federal Reserve) and the Office of the Comptroller of the Currency (OCC) issued a joint proposal to amend their respective risk-based capital standards (59 FR 26456) in accordance with the Basle Supervisors' Committee's April 1993 proposal. The Office of Thrift Supervision (OTS) issued a similar netting proposal on June 14, 1994 (59 FR 30538) and the FDIC issued its netting proposal on July 25, 1994 (59 FR 37726). (Collectively, the FDIC, Federal Reserve, OCC and OTS are referred to as the banking agencies.) The banking agencies each proposed that for capital purposes the organizations under their

supervision could net the positive and negative market values of
interest and exchange rate contracts subject to a qualifying, legally
enforceable, bilateral netting contract to calculate one current
exposure for that master netting contract.

The banking agencies' proposals provided that the net current
exposure would be determined by adding together all positive and
negative market values of individual contracts subject to the netting
contract. The net current exposure would equal the sum of the market
values if that sum is a positive value, or zero if the sum of the
market values is zero or a negative value. The proposals did not alter
the calculation method for potential future exposure.[5]

\5\Potential future exposure is estimated by multiplying the
effective notional amount of a contract by a credit conversion
factor which is based on the type of contract and the remaining
maturity of the contract. Under the FDIC's proposal, a potential
future exposure amount would be calculated for each individual
contract subject to the netting contract. The individual potential
future exposures would then be added together to arrive at one total
add-on amount.

Under the banking agencies' proposals, institutions would be able
to net for risk-based capital purposes only with a written bilateral
netting contract that creates a single legal obligation covering all
included individual rate contracts and does not contain a walkaway
clause.[6] The proposals required an institution to obtain a written
and reasoned legal opinion(s) stating that under the master netting
contract the institution would have a claim to receive, or an
obligation to pay, only the net amount of the sum of the positive and
negative market values of included individual contracts if a
counterparty failed to perform due to default, insolvency, bankruptcy,
liquidation, or similar circumstances.

\6\A walkaway clause is a provision in a netting contract that
permits a non-defaulting counterparty to make lower payments than it
would make otherwise under the contract, or no payment at all, to a
defaulter or to the estate of a defaulter, even if the defaulter or
the estate of the defaulter is a net creditor under the contract.

The banking agencies' proposals indicated that the legal opinion
must normally cover: (i) The law of the jurisdiction in which the
counterparty is chartered, or the equivalent location in the case of

noncorporate entities, and if a branch of the counterparty is involved, the law of the jurisdiction in which the branch is located; (ii) the law that governs the individual contracts covered by the netting contract; and (iii) the law that governs the netting contract.

The banking agencies' proposals provided that an institution must maintain in its files documentation adequate to support the bilateral netting contract. Documentation would typically include a copy of the bilateral netting contract, legal opinions and any related translations. In addition, the proposals required an institution to establish and maintain procedures to ensure that the legal characteristics of netting contracts would be kept under review.

Under the proposals, the banking agencies could disqualify any or all contracts from netting treatment for risk-based capital purposes if the requirements of the proposals were not satisfied. In the event of disqualification, the affected contracts would be treated as though they were not subject to the master netting contract. The proposals indicated that outstanding netting by novation arrangements would not be grandfathered, that is, such arrangements would have to meet all of the proposed requirements for qualifying bilateral netting contracts.

The proposals requested general comments as well as specific comments on the nature of collateral arrangements and the extent to which collateral might be recognized in conjunction with bilateral netting contracts.

Comments Received

The banking agencies together received twenty-two public comments on their proposed amendments. Since all the comment letters were shared by the banking agencies, all of them will be discussed herein. Twelve of the commenters were banks, thrifts, and bank and thrift holding companies and five were industry trade associations and organizations. In addition, there were two comments from foreign financial institutions and three comments from law firms. All commenters supported the expanded recognition of bilateral netting contracts for risk-based capital purposes. Several commenters encouraged recognition of such contracts as quickly as possible. Many of the commenters concurred with one of the principal underlying tenets of the proposals, that is, that legally enforceable bilateral netting contracts can provide an efficient and desirable means for institutions to reduce or control credit exposure. A few commenters noted that, in their view, the recognition of bilateral netting contracts would create an incentive for market participants to use such arrangements and would encourage lawmakers to clarify the legal status of netting arrangements in their jurisdictions. One commenter noted that the expanded recognition of bilateral netting contracts would help keep U.S. banking organizations competitive in global derivatives markets.

While generally expressing their endorsement for the expanded recognition of bilateral netting contracts, nearly all commenters offered suggestions or requested clarification regarding details of the proposals. In particular, the commenters raised issues concerning specifics of the required legal opinions, the treatment of collateral, and the grandfathering of walkaway clauses and novation agreements.

Legal Opinions

Almost all commenters addressed the proposed requirement that institutions obtain legal opinions concluding that their bilateral netting contracts would be enforceable in all relevant jurisdictions. Commenters did not object to the general requirement that they secure legal opinions, rather they raised a number of questions about the form and substance of an acceptable opinion.

Form

Several commenters requested clarification as to the specific form of the legal opinion. Commenters wanted to know if a memorandum of law would satisfy the requirement or if a legal opinion would be required. They questioned whether a memorandum or opinion could be addressed to, or obtained by, an industry group, and whether a generic opinion or memorandum relating to a standardized netting contract would satisfy the legal opinion requirement.

Several commenters suggested that an opinion secured on behalf of the banking industry by an organization should be sufficient so long as the individual institution's counsel concurs with the opinion and concludes that the opinion applies directly to the institution's specific netting contract and to the individual contracts subject to it. A few commenters requested confirmation that legal opinions would not have to follow a predetermined format.

Scope

Several commenters identified two possible interpretations of the proposed language with regard to the scope of the legal opinions. They asked the banking agencies to clarify whether the opinions would be required to discuss only whether all relevant jurisdictions would recognize the contractual choice of law or whether they must also discuss the enforceability of netting in bankruptcy or other instances of default. One commenter suggested deleting the requirement for a choice of law analysis.

A number of commenters objected to the proposed requirement that the legal opinion for a multibranch netting contract (that is, a netting contract between multinational banks that includes contracts with branches of the parties located in various jurisdictions) address the enforceability of netting under the law of the jurisdiction where each branch is located. These commenters stated that it should be sufficient for the legal opinion to conclude that netting would be

enforced in the jurisdiction of the counterparty's home office if the master netting contract provides that all transactions are considered obligations of the home office and the branch jurisdictions recognize that provision.

Severability

Several commenters expressed concern about the proposed treatment for netting contracts that include contracts with branches in jurisdictions where the enforceability of netting is unclear. In such circumstances, commenters asserted, unenforceability or uncertainty in one jurisdiction should not invalidate the entire netting contract for risk-based capital netting treatment. These commenters contended that, to the extent supported by legal opinions, contracts with branches of a counterparty in jurisdictions that recognize netting arrangements should be netted and contracts with branches in jurisdictions where the enforceability of netting is not supported by legal opinions should, for risk-based capital purposes, be severed, or removed, from the master netting contract and treated as though they were not subject to that contract. These commenters noted that this treatment should only be available to the extent it is supported by legal opinion.

Conclusions

The proposals required a legal opinion to conclude that ``relevant court and administrative authorities would find'' the netting to be effective. Many commenters that discussed this aspect of the proposals expressed concern that this standard was too high. They suggested, instead, that the opinions be required to conclude that netting ``should'' be effective.

A few commenters requested clarification regarding the proposed requirement that the netting contract must create a single legal obligation.

Collateral

Twelve commenters addressed the proposals' specific request for comment on the nature of collateral and the extent to which collateral might be recognized in conjunction with bilateral netting contracts. All of these commenters believed collateral should be recognized as a means of reducing credit exposure. A few commenters noted that collateral arrangements are increasingly being used with derivative transactions.

Several commenters stated that for netting contracts that call for the use of collateral, the amount of required collateral is determined from the net mark-to-market value of the master netting contract. A few commenters added that mark-to-market collateral often is used in conjunction with a collateral ``add-on'' based on such things as the notional amount of the underlying contracts, the maturities of the contracts, the credit quality of the counterparty, and volatility

levels.
A number of commenters offered their opinions as to how collateral should be recognized for risk-based capital purposes. Some suggested that the existing method of recognizing collateral for purposes of assigning credit equivalent amounts to risk categories is applicable to derivative transactions as well. Other commenters expressed the view that collateral should be recognized when assigning risk weights to the extent it is legally available to cover the total credit exposure for the bilateral netting contract in the event of default and that this availability should be addressed in the legal opinions.

Several other commenters suggested separating the net current exposure and potential future exposure of bilateral netting contracts for determining collateral coverage and appropriate risk weights. One commenter favored recognizing collateral for capital purposes by allowing an institution to offset net current exposure by the amount of the collateral to further reduce the credit equivalent amount.

Two commenters requested clarification that contracts subject to qualifying netting contracts could be eligible for a zero percent risk weight if the transaction is properly collateralized in accordance with the Federal Reserve's collateralized transactions rule.[7]

\7\In December 1992, the Federal Reserve issued an amendment to its risk-based capital guidelines permitting certain collateralized transactions to qualify for a zero percent risk weight (57 FR 62180, December 30, 1992). In order to qualify for a zero percent risk weight, an institution must maintain a positive margin of qualifying collateral at all times. Thus, the collateral arrangement should provide for immediate liquidation of the claim in the event that a positive margin of collateral is not maintained. The OCC has issued a similar proposal (58 FR 43822, August 18, 1993).

Walkaway Clauses

Several commenters addressed the proposed prohibition against walkaway clauses in contracts qualifying for netting for risk-based capital purposes. While most of these commenters agreed that, ultimately, walkaway clauses should be eliminated from master netting contracts, they favored a phase-out period, during which outstanding bilateral netting contracts containing walkaway clauses could qualify for capital netting treatment. Several commenters contended that if a defaulter is a net debtor under the contract, the existence of a walkaway clause would not affect the amount owed to the non-defaulting creditor.

Novation

A few commenters expressed concern that the banking agencies' proposals did not grandfather outstanding novation agreements. These commenters suggested a phase-in period during which novation agreements would not be required to be supported by legal opinions.

Other Issues

One commenter requested greater detail on the nature and extent of examination review procedures. Two commenters stated that in some situations obtaining translations might be burdensome. Another commenter suggested assurance that the agencies would not disqualify netting contracts in an unreasonable manner.

Approximately one-half of the commenters expressed concern that the banking agencies' proposals specifically were limited to interest rate and exchange rate contracts. All of these opposed limiting the range of products that could be included under qualifying netting contracts. In this regard, one commenter noted that where there is sufficient legal support confirming the enforceability of cross-product netting it should be recognized for capital purposes.

A number of commenters used the proposal as an opportunity to discuss the manner in which the add-on for potential future exposure is calculated. They suggested netting contracts should be recognized not only as a way to reduce the current exposure to a counterparty, but also the effects of such netting contracts should be taken into account to reduce the amount of capital organizations must hold against the potential future exposure to the counterparty.

Final Rule

After considering the public comments received and further deliberating the issues involved, the FDIC has determined to adopt a final rule recognizing, for capital purposes, qualifying bilateral netting contracts. This final rule is substantially the same as proposed.

Legal opinions

Form

The final rule requires that banks obtain a written and reasoned legal opinion(s) concluding that the netting contract is enforceable in all relevant jurisdictions. This requirement is aimed at ensuring there is a substantial legal basis supporting the legal enforceability of a netting contract before reducing a bank's capital requirement based on that netting contract. A legal opinion, as that phrase is commonly

understood by the legal community in the United States, can provide such a legal basis. A memorandum of law may be an acceptable alternative as long as it addresses all of the relevant issues in a credible manner.

As discussed in the proposal, the legal opinion may be prepared by either an outside law firm or a bank's in-house counsel. The salient requirements for an acceptable legal opinion are that it: (i) Addresses all relevant jurisdictions; and (ii) concludes with a high degree of certainty that in the event of a legal challenge the bank's claim or obligation would be determined by the relevant court or administrative authority to be the net sum of the positive and negative mark-to-market values of all individual contracts subject to the bilateral netting contract. The subject matter and complexity of required legal opinions will vary.

To some extent, banks may use general, standardized opinions to help support the legal enforceability of their bilateral netting contracts. For example, a bank may have obtained a memorandum of law addressing the enforceability of netting provisions in a particular foreign jurisdiction. This opinion may be used as the basis for recognizing netting generally in that jurisdiction. However, with regard to an individual master netting contract, the general opinion would need to be supplemented by an opinion that addresses issues such as the enforceability of the underlying contracts, choice of law, and severability.

For example, the FDIC does not believe that a generic opinion prepared for a trade association with respect to the effectiveness of netting under the standard form agreement issued by the trade association, by itself is adequate to support a netting contract. Banks using such general opinions would need to supplement them with a review of the terms of the specific netting contract that the bank is executing.

Scope

With regard to the scope of the legal opinions, that is, what areas of analysis must be covered, the FDIC is of the opinion that legal opinions must address the validity and enforceability of the entire netting contract. The opinion must conclude that under the applicable state or other jurisdictional law the netting contract is a legal, valid, and binding contract, enforceable in accordance with its terms, even in the event of insolvency, bankruptcy, or similar proceedings. Opinions provided on the law of jurisdictions outside of the U.S. should include a discussion and conclusion that netting provisions do not violate the public policy or the law of that jurisdiction.

The FDIC has further determined that one of the most critical aspects of a qualifying netting contract is the contract's enforceability in any jurisdiction whose law would likely be applied in an enforcement action, as well as the jurisdiction where the

counterparty's assets reside. In this regard, and in light of the policy in some countries to liquidate branches of foreign banking organizations independent of the head office, the FDIC is retaining its proposed requirement that legal opinions address the netting contract's enforceability under: (i) The law of the jurisdiction in which the counterparty is chartered, or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, the law of the jurisdiction in which the branch is located; (ii) the law that governs the individual contracts subject to the bilateral netting contract; and (iii) the law that governs the netting contract.

Severability

The FDIC recognizes that for some multibranch netting contracts a bank may not be able to obtain a legal opinion(s) concluding that netting would be enforceable in every jurisdiction where branches covered under the master netting contract are located. The FDIC concurs with commenters that in such situations it may be inefficient to require banks to renegotiate netting contracts to ensure they cover only those jurisdictions where netting is clearly enforceable. The FDIC has determined that, in certain circumstances for capital purposes, banks may use master bilateral netting contracts that include contracts with branches across all jurisdictions. Banks should calculate their net current exposure for the contracts in those jurisdictions where netting clearly is enforceable as supported by legal opinion(s). The remaining contracts subject to the netting contract should be severed from the netting contract and treated as though they were not subject to the netting contract for capital and credit purposes. This approach of essentially dividing contracts subject to the netting contact into two categories--those that may clearly be netted and those that may not--is acceptable provided that the bank's legal opinions conclude that the contracts that do not qualify for netting treatment are legally severable from the master netting contract and that such severance will not undermine the enforceability of the netting contract for the remaining qualifying contracts.

Conclusions

The FDIC has retained the proposed language that legal opinions must represent that netting would be enforceable in all relevant jurisdictions. In response to commenters' assertions that the standard for this type of legal opinion is too high, the FDIC notes that use of the word ``would'' in the capital rules does not necessarily mean that the legal opinions must also use the word ``would'' or that enforceability must be determined to be an absolute certainty. The intent, rather, is for banks to secure a legal opinion concluding that there is a high degree of certainty that the netting contract will survive a legal challenge in any applicable jurisdiction. The degree of certainty should be apparent from the reasoning set out in the opinion.

The FDIC notes that the requirement for legal opinions to conclude

that netting contracts must create a single legal obligation applies only to those individual contracts that are covered by, and included under, the netting contract for capital purposes. As discussed above, a netting contract may include individual contracts that do not qualify for netting treatment, provided that these individual contracts are legally severable from the contracts to be netted for capital purposes.

Collateral

The final rule permits, subject to certain conditions, banks to take into account qualifying collateral when assigning the credit equivalent amount of a netting contract to the appropriate risk weight category in accordance with the procedures and requirements currently set forth in the FDIC's risk-based capital standards. The FDIC has added language to the final rule clarifying that collateral must be legally available to cover the credit exposure of the netting contract in the event of default. For example, the collateral may not be pledged solely against one individual contract subject to the master netting contract. The legal availability of the collateral must be addressed in the legal opinions.

Walkaway Clauses

The FDIC has considered the suggestion made by some commenters of a phase-out period for outstanding contracts with walkaway clauses. The FDIC continues to believe that walkaway clauses do not reduce credit risk. Accordingly, the final rule retains the provision that bilateral netting contracts with walkaway clauses are not eligible for netting treatment for risk-based capital purposes and does not provide for a phase-out period.

Novation

The proposal required all netting contracts, including netting by novation agreements, to be supported by written legal opinions. The FDIC does not agree with commenters that a grandfathering period for outstanding novation agreements is needed. Rather, the FDIC continues to believe that all netting contracts must be held to the same standards in order to promote certainty as to the legal enforceability of the contracts and to decrease the risks faced by counterparties in the event of default. Under the final rule, a netting by novation agreement must meet the requirements for a qualifying bilateral netting contract.

Other Issues

The FDIC has considered all of the other issues raised by commenters. With regard to documentation, the FDIC reiterates that, as with all provisions of risk-based capital, a bank must maintain in its files appropriate documentation to support any particular capital treatment including netting of rate contracts. Appropriate documentation typically would include a copy of the bilateral netting contract, supporting legal opinions, and any related translations. The documentation should be available to examiners for their review.

The FDIC recognizes commenters' concerns that the proposed rules were limited specifically to interest and exchange rate contracts. The FDIC notes that both the Basle Accord and its risk-based capital standards currently do not address derivatives contracts other than rate contracts. This final rule does not attempt to go beyond the scope of the existing risk-based capital framework and applies only to netting contracts encompassing interest rate and foreign exchange rate contracts. The FDIC, however, notes that the Basle Supervisors' Committee issued a proposal for public comment in July 1994 to amend the Basle Accord which explicitly would set forth the risk-based capital treatment for other types of derivative transactions, such as commodity, precious metal, and equity contracts. In this regard, the Federal Reserve, the OCC, and the FDIC issued similar proposals, based on the Basle Supervisors' Committee proposal, to amend their risk-based capital standards (59 FR 43508, August 24, 1994; 59 FR 45243, September 1, 1994; and 59 FR 52714, October 19, 1994, respectively). The OTS intends to issue a similar proposal in the near future.

Until the Basle Accord has been revised and the FDIC's risk-based capital rules have been amended to encompass commodity, precious metal, and equity derivative contracts, the FDIC will permit banks to apply the following treatment, rather than automatically disqualifying from capital netting treatment an entire netting contract that includes non-rate-related transactions. In determining the current exposure of otherwise qualifying netting contracts that include non-rate-related contracts, banks will be permitted to net the positive and negative mark-to-market values of the included interest and exchange rate contracts, while severing the non-rate-related contracts and treating them as though they were not subject to the master netting contract. (This treatment is similar to the treatment applied to a netting contract that includes contracts in jurisdictions where the enforceability of netting is not supported by legal opinion. Legal opinions are not required to support severability of non-rate-related contracts.)

The FDIC notes that the regulatory language with regard to the calculation of potential future exposure remains essentially the same as that proposed. The FDIC has clarified an underlying premise of the current exposure method for calculating credit exposure as set forth in the Basle Accord, that is, the add-on for potential future exposure

must be calculated based on the effective, rather than the apparent, notional principal amount and the notional amount the bank uses will be subject to examiner review.[8]

\8\The notional amount is, generally, a stated reference amount of money used to calculate payment streams between the counterparties. In the event that the effect of the notional amount is leveraged or enhanced by the structure of the transaction, banks must use the actual, or effective, notional amount when determining potential future exposure. For example, a stated notional amount of one million dollars with payments calculated at 2X Libor, would have an effective notional amount of two million dollars.

Finally, in its Notice of Proposed Rulemaking, the FDIC described its transfer and enforcement powers with respect to ``qualified financial contracts'' under section 11(e) of the FDI Act. (59 FR 37229-30). Having received no comments on that subject, the FDIC reaffirms its position as stated in the Notice of Proposed Rulemaking.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the FDIC hereby certifies that this final rule will not have a significant impact on a substantial number of small business entities. Accordingly, a regulatory flexibility analysis is not required.

Paperwork Reduction Act and Regulatory Burden

The FDIC has determined that this final rule will not increase the regulatory paperwork burden of banks pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.).

Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Pub. L. 103-325, 108 Stat. 2160) provides that the federal banking agencies must consider the administrative burdens and benefits of any new regulation that imposes additional requirements on insured depository institutions. Section 302 also requires such a rule to take effect on the first day of the calendar quarter following final publication of the rule, unless the agency, for good cause, determines an earlier effective date is appropriate.

The new capital rule imposes certain requirements on banks that wish to net the current exposures of their rate contracts for purposes of calculating their risk-based capital requirements. However, the FDIC expects that such banks would adhere to these requirements in any event as part of prudent business practices. Any burden of complying with the

requirements of netting under a legally enforceable netting contract and obtaining the necessary legal opinions should be outweighed by the benefits associated with a lower capital requirement. The new rule will not affect banks that do not wish to net for capital purposes. For these reasons, the FDIC has determined that the rule is to be effective on the date published, and banks will be permitted to take advantage of netting in their year-end statements, if they so desire.

List of Subjects in 12 CFR Part 325

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

For the reasons set out in the preamble, the Board of Directors of the FDIC amends 12 CFR part 325 as follows:

PART 325--CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 3907, 3909; Pub.L. 102-233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note) Pub.L. 102-242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. Appendix A to part 325 is amended by revising section II.E.1 introductory text, Section II.E.1.(a) and (b) and the undesignated paragraph after section II.E.1.(b) preceding the table; revising the first paragraph of section II.E.2.; removing the last two sentences of the second paragraph of section II.E.2; and adding new II.E.3. to read as follows:

Appendix A to Part 325--Statement of Policy on Risk-based Capital

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II. * * *

E. * * *

1. Credit Equivalent Amounts for Interest Rate and Foreign Exchange Rate Contracts. The credit equivalent amount of an off-balance sheet rate contract that is not subject to a qualifying bilateral netting contract in accordance with section II.E.3. of this appendix A is equal to the sum of (i) the current exposure (which is equal to the mark-to-market value[39] and is sometimes

referred to as the replacement cost) of the contract; and (ii) an estimate of the potential future credit exposure over the remaining life of the contract. To calculate the credit equivalent amount of its off-balance sheet interest rate and foreign exchange rate instruments, a bank should, for each contract, sum:

\3\9Mark-to-market values should be measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in both interest (or foreign exchange) rates and in counterparty credit quality.

(a) The mark-to-market value (positive values only) of the contact (that is, its current credit exposure or replacement cost); and

(b) An estimate of the potential future increase in credit exposure over the remaining life of the instrument.

For risk based capital purposes, potential credit exposure on a contract is determined by multiplying the notional principal amount of the contract, including contracts with negative mark-to-market values, by the appropriate credit conversion factor. Banks should, subject to examiner review, use the effective rather than the apparent or stated notional amount in this calculation.[40] The conversion factors are:

\4\0The notional amount is, generally, a stated reference amount of money used to calculate payment streams between the counterparties. In the event that the effect of the notional amount is leveraged or enhanced by the structure of the transaction, institutions must use the actual, or effective, notional amount when determining potential future exposure. For example, a stated notional amount of one million dollars with payments calculated at 2X Libor, would have an effective notional amount of two million dollars.

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2. Risk Weights for Interest Rate and Foreign Exchange Rate Contracts. Once the credit equivalent amount for an interest rate and foreign exchange rate instrument has been determined, that amount generally should be assigned to a risk weight category according to the identity of the counterparty or, if relevant, the nature of any collateral or guarantees. Collateral held against a netting contract is not recognized for capital purposes unless it is

legally available for all contracts included in the netting contract. However, the maximum risk weight that will be applied to the credit equivalent amount of such instruments is 50 percent.

* * * * *

3. Netting. (1) For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values when determining a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting of rate contracts is recognized for purposes of calculating the credit equivalent amount provided that:

(a) The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the bank would have a claim or obligation to receive or pay, respectively, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: default, bankruptcy, liquidation, or similar circumstances.

(b) The bank obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy or similar circumstances, the relevant court and administrative authorities would find the bank's exposure to be such a net amount under:

(i) The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities and, if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

(ii) The law that governs the individual contracts covered by the netting contract; and

(iii) The law that governs the netting contract.

(c) The bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law.

(d) The bank maintains in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

(2) A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.[41]

\4\1For purposes of this section, a walkaway clause means a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the

estate of a defaulter, even if a defaulter or the estate of a
defaulter is a net creditor under the contract.

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(3) By netting individual contracts for the purpose of calculating its credit equivalent amount, a bank represents that it has met the requirements of this appendix A and all the appropriate documents are in the bank's files and available for inspection by the FDIC. Upon determination by the FDIC that a bank's files are inadequate or that a netting contract may not be legally enforceable under any one of the bodies of law described in paragraphs (b)(i) through (iii) of this section, underlying individual contracts may be treated as though they were not subject to the netting contract.

(4) The credit equivalent amount of rate contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract and (ii) the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract.

(5) The current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero.

(6) For each individual contract included in the netting contract, the potential future credit exposure is estimated in accordance with section II.E.1. of this appendix A.[42]

\4\2For purposes of calculating potential future credit exposure for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts to each party falling due on each value date in each currency.

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(7) Examples of the calculation of credit equivalent amounts for these types of contracts are contained in Table IV.

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3. Appendix A to part 325 is amended by removing the last three sentences of the last paragraph under the heading ``Credit Conversion for Interest Rate and Foreign Exchange Rate Related Contracts'' in Table III and adding in their place two new sentences and by adding new Table IV to read as follows:

* * * * *

Table III.--Credit Conversion Factors for Off-Balance Sheet Items

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Credit Conversion for Interest Rate and Foreign Exchange Rate Related Contracts

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* * * In the event a netting contract covers transactions that are normally not included in the risk-based ratio calculation--for example, exchange rate contracts with an original maturity of fourteen calendar days or less or instruments traded on exchanges that require daily payment of variation margin--an institution may elect to consistently either include or exclude all mark-to-market values of such transactions when determining a net current exposure. Multiple contracts with the same counterparty may be netted for risk-based capital purposes pursuant to section II.E.3. of this appendix.

Table IV--Calculation of Credit Equivalent Amounts for Interest Rate and Foreign Exchange Rate Related Transactions for State Nonmember Banks

Type of contract (remaining maturity)	Potential exposure: Notional principal (dollars)	Potential exposure: Conversion factor	Potential exposure: Potential exposure (dollars)	+ Current exposure: Mark-to-market value	Current exposure: Current exposure (dollars)	= Credit equivalent amount
(1) 120-day forward foreign exchange..................	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 120-day forward foreign exchange..................	6,000,000	.01	60,000	-120,000	0	60,000
(3) 3-year interest rate swap......................	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 3-year interest rate swap......................	10,000,000	.005	50,000	-250,000	0	50,000
(5) 7-year foreign exchange						

swap......................	20,000,000	.05	1,000,000	-1,300,000	0	1,000,000
Total................	....	....	1,210,000	....	300,000	1,510,000

If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

	Potential future exposure (from above)	Net current exposure\1\	Credit equivalent amount
(1)................	50,000		
(2)................	60,000		
(3)................	50,000		
(4)................	50,000		
(5)................	1,000,000		
Total.........	1,210,000 +	0 =	1,210,000

\1\The total of the mark-to-market values from above is -1,370,000. Since this is a negative amount, the net current exposure is zero.

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By order of the Board of Directors.

Dated at Washington, DC, this 20th day of December, 1994.

Federal Deposit Insurance Corporation.
Robert E. Feldman,
Acting Executive Secretary.

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