Statement
of
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The Financial Institutions Insolvency Improvement Act of 1999
Subcommittee on Financial Institutions
Committee on Banking, Housing, and Urban Affairs
United States Senate
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Chairman Bennett, Ranking Member Bryan, and members of the Subcommittee, on behalf of the Federal Deposit Insurance Corporation, I appreciate the opportunity to present our views on legislation designed to update laws governing the treatment of certain financial contracts at insolvent banks. In particular, I would like to commend you, Mr. Chairman, for introducing the Financial Institutions Insolvency Improvement Act of 1999.

The Financial Institutions Insolvency Improvement Act of 1999 adopts proposals of the President's Working Group on Financial Markets. The FDIC participated on the Working Group and assisted in drafting the proposals. We strongly support this legislation and urge its prompt passage. Your legislation, Mr. Chairman, represents that portion of the Working Group’s recommendations that would amend banking statutes. Other provisions in the Working Group’s proposals that change bankruptcy law have been introduced by Senator Grassley as Title IX of S. 625. It is important that both these bills be enacted.

The legislation will result in more consistent and predictable rules to govern events when one party to a financial derivative contract becomes insolvent. Enactment of the bills 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 assess more accurately and to manage the risks arising from derivative contracts. The Financial Institutions Insolvency Improvement Act will clarify the FDIC's right, as the receiver for failed banks and thrifts, to transfer qualified financial contracts (QFCs). In addition, the legislation will enhance the ability of the FDIC to transfer QFCs from the failed bank or thrift to new solvent parties, thereby reducing disruption of contracts and financial markets.

The Role of Derivatives and Cross-Netting

I would like to provide some background on the role that financial derivatives play in our financial markets and economy. Banks and corporations use derivative contracts to shape 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. In addition, 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.

The benefits of derivative 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. Derivative 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.

One of the key elements in reducing risk to the capital markets is the availability of close-out netting for certain types of financial contracts in the event of the insolvency of one party. Netting may be defined as taking what I owe you and what you owe me on several contracts and subtracting or "netting" those two figures to arrive at a single amount for payment by one of us. Netting can be a valuable credit risk management tool in all multiple transaction relationships by reducing the credit and liquidity exposures to counterparty insolvency. It does this by eliminating large funds transfers for each transaction in favor of a smaller net payment.

With the adoption of the Bankruptcy Code in 1978 and amendments to the Federal Deposit Insurance Act (FDI Act) in 1989, federal law has been amended to provide greater certainty to participants in our capital markets if one party becomes insolvent. The series of "netting" amendments to the Bankruptcy Code and the FDI Act over the past two decades were designed to further the policy goal of minimizing the systemic risks potentially arising from certain interrelated financial activities and markets. Systemic risk has been defined as the risk that a disruption -- at a firm, in a market segment, to a settlement system, etc. -- can cause widespread difficulties at other firms, in other market segments or in the financial system as a whole. Netting helps reduce this risk by reducing the number and size of payments necessary to complete transactions. As a result, it allows greater liquidity in the system by reducing the amounts necessary for each party to settle its transactions. If participants in certain financial activities are unable to enforce their rights to terminate financial contracts with an insolvent entity in a timely manner, and offset or net payment and other transfer obligations and entitlements arising under such contracts, the resulting uncertainty and potential lack of liquidity could increase the risk of an inter-market disruption.

Statutory Background

The FDI Act, the Federal Deposit Insurance Corporation Improvement Act (FDICIA), the Bankruptcy Code, and the Securities Investor Protection Act of 1970 are the principal statutes that determine what happens to derivative and related financial contracts when one party becomes insolvent. These laws vary significantly in how they define

applicable contracts and the rights and obligations 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 harmonizing the definitions and substantive provisions of these statutes.

The Bankruptcy Code governs insolvency proceedings for most corporations, while the Securities Investor Protection Act of 1970 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.

In these statutes, Congress has taken steps to enhance the availability of netting for derivatives and to minimize the risk of a system-wide disruption in our financial markets. For example, both the Bankruptcy Code and the FDI Act contain provisions that protect the rights of financial participants to terminate certain types of financial contracts following the bankruptcy or insolvency of a counterparty to such contracts or agreements. Furthermore, other provisions prevent transfers made under such circumstances from being avoided as preferences or fraudulent conveyances (except when made with actual intent to defraud). Protections also are afforded under U.S. law to ensure that the netting, set off and collateral foreclosure provisions of such transactions and master agreements for such transactions are enforceable. Finally, FDICIA protects the enforceability of close-out netting provisions in "netting contracts" between "financial institutions." FDICIA states that the goal of enforcing netting arrangements is to reduce systemic risk within the banking system and financial markets.

The FDI Act confirms the availability of close-out netting when an insured bank or thrift fails. It does so by allowing counterparties to specifically defined contracts, QFCs, to terminate their contracts, net their exposures and recoup positive claims against the failed bank or thrift from any security provided before the failure. QFCs are defined as consisting primarily of financial derivatives and similar instruments and are further 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. 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. 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. 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 financial 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 the FDI Act), and the recoverable damages may include reasonable costs of cover or other reasonable measures of damages used in the industry.

When enacted in 1991, Sections 402 through 404 of FDICIA provided 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." 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).

Both 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.

While these laws provide significant assurances that the risk reduction benefits of close-out netting are available under U.S. law, the provisions of the Financial Institutions Insolvency Improvement Act of 1999 and Title IX of S. 625 are important steps toward harmonizing these statutory provisions which were enacted over more than a decade. This legislation permits our statutes to remain abreast of innovations that have occurred in financial markets since 1989, and is a crucial step to maintaining the U.S. as the leader in financial innovation and risk management.

Provisions of the Legislation

The legislation addresses several significant issues for bank receiverships, while providing additional clarification and consistency that reduces systemic risk in all insolvencies. The bills include three principal elements.

First, the legislation strengthens the statutory protections for netting of financial market contracts. It revises and clarifies the definitions of the types of contracts that benefit

from netting in line with market innovations and practice. This provides additional certainty to market participants and improves their ability to accurately assess and manage risks. The legislation also clarifies that, under the FDI Act and the Bankruptcy Code, cross-product netting can be achieved through the use of a master netting contract. As a result, the legislation would expand the availability of the risk-reduction benefits of close-out netting to agreements encompassing a number of financial market contracts and, thereby, further reduce the potential settlement risks to market participants.

Second, the proposed legislation makes the treatment of financial market contracts more consistent under the FDI Act and the Bankruptcy Code. Improved consistency between the insolvency regimes applicable to banks and non-banks has been one of the primary goals of the Working Group. There is little justification for treating identical financial market contracts differently dependent solely upon whether the counterparty is an insured depository institution subject to the FDI Act or an entity subject to the Bankruptcy Code. The importance of consistent insolvency treatment to risk management in the financial markets strongly recommends enactment of this legislation.

The legislation also provides certain additional substantive and technical amendments that clarify certain provisions and improve the consistency in the treatment of these financial market contracts between applicable laws. For example, the legislation would apply the same rules to uninsured national banks and Federal branches and agencies that apply to insured institutions in order to limit inconsistencies. These changes will go far to providing a clear playing field for market participants.

Third, the legislation clarifies the rights of the FDIC as receiver for a failed bank or thrift. An important component of reducing systemic risk to the financial system is the orderly resolution of insolvencies involving counterparties to such contracts. The FDI Act allows the FDIC, when serving as receiver for an insolvent insured depository institution, the opportunity to review the status of certain contracts to determine whether to terminate or transfer the contracts to new counterparties. These provisions provide the receiver with flexibility in determining the most appropriate resolution for the failed institution and facilitate the reduction of systemic risk by permitting the transfer, rather than termination, of such contracts. These provisions also are important to permit the FDIC to fulfill its statutory mission to preserve confidence in our banking system by protecting insured depositors and promptly resolving insured banks and thrifts that fail.

To ensure an orderly resolution of such insolvencies, the proposed legislation clarifies that under the FDI Act, a conservator or receiver of a depository institution has one business day to transfer qualified financial contracts to another financial institution. This clarification will help ensure that the resolution of a failed depository institution can be accomplished at the lowest possible cost to the deposit insurance funds administered by the FDIC, while preserving for market participants the ability to promptly net out their contracts with failed depository institutions.

We believe the legislative proposal will reduce systemic risk in our financial markets, while balancing the public interest in effective and orderly resolution of failed insured banks and thrifts. Clarification of these provisions also is important for the continuation of financial market innovations and for continued stability and growth of our financial system. This legislation will play an important role in allowing the United States to maintain its world leadership in providing a legal structure that facilitates prudent oversight and risk management while protecting the markets from systemic risks potentially created by insolvencies of market participants by ensuring the availability of termination and close-out netting.

In closing, let me reiterate the FDIC's support for the Financial Institutions Insolvency Improvement Act of 1999. Passage of the improvements to the netting of financial contracts 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.

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