FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

June 4, 1993

DALLAS, TEXAS 75222

Notice 93-61

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Request for Public Comment on a Proposed New Rule--Regulation EE (Netting Eligibility for Financial Institutions)

DETAILS

The Federal Reserve Board has issued for public comment a proposed rule to expand the definition of "financial institution" in Section 402 of the Federal Deposit Insurance Corporation Improvement Act (Act). The Act validates netting contracts among financial institutions.

The Act defines "financial institution" to include a securities broker or dealer, a depository institution, a futures commission merchant, or any other institution as determined by the Board. The proposed rule would establish a category of entities considered financial institutions under the Act, while reserving the ability to expand that category further through individual determinations.

Parties to a netting contract agree that they will pay or receive the net, rather than the gross, payment due under the netting contract. The Act provides certainty that netting contracts will be enforced, even in the event of the insolvency of one of the parties. The Act's netting provisions, effective December 19, 1991, were designed to promote efficiency and reduce systemic risk within the banking system and financial markets.

The Board must receive comments by August 20, 1993. Comments should be addressed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. All comments should refer to Docket No. R-0801.

ATTACHMENT

A copy of the Board's notice as it appears on pages 29149-52, Vol. 58, No. 95, of the Federal Register dated May 19, 1993, is attached.

MORE INFORMATION

For more information, please contact Jane Anne Schmoker at (214) 922-5104. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

FEDERAL RESERVE SYSTEM

12 CFR Part 231

[Regulation EE; Docket No. R-0801]

Netting Eligibility for Financial Institutions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board is requesting comment on a rule to include certain entities under the definition of "financial institution" in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991 so that they will be covered by the Act's netting provisions. The Act authorizes the Board to expand the definition of "financial institution" to the extent consistent with the purposes of enhancing efficiency and reducing systemic risk in the financial markets.

DATES: Comments must be submitted on or before August 20, 1993.

ADDRESSES: Comments, which should refer to Docket No. R-0801, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Comments addressed to Mr. Wiles also may be delivered to the Board's mail room between 8:45 am and 5:15 pm and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in Room B-1122 between 9 am and 5 pm.

FOR FURTHER INFORMATION CONTACT: Oliver Ireland, Associate General Counsel (202/452-3625), or Stephanie Martin, Senior Attorney (202/452-3198), Legal Division, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

The Federal Deposit Insurance Corporation Improvement Act of 1991 (Act) (Pub. L. 102-242, sections 401-407; 105 Stat. 2236, 2372-3; 12 U.S.C. 4401-4407) validates netting contracts among financial institutions. Parties to a netting contract agree that they will pay or receive the net, rather than the gross, payment due under the netting contract. The Act provides certainty that netting contracts will be enforced, even in the event of the insolvency of one of the parties. The Act's netting provisions, effective December 19, 1991, were designed to promote efficiency and reduce systemic risk within the banking system and financial markets.

The netting provisions apply to bilateral netting contracts between two financial institutions and multilateral netting contracts among members of a clearing organization.[1] Section 4402(9)

[1] "Clearing organization" means a clearinghouse, clearing association, clearing corporation, or similar organization—

(A) That provides clearing, netting, or settlement services for its members and—

Continued

of the Act defines "financial institution" to include a depository institution, a securities broker or dealer, or a futures commission merchant. Section 4402(9) also authorizes the Board to determine whether institutions that do not fall within the Act's definition may be considered financial institutions for purposes of the netting provisions. In addition, the Act's definition of "broker or dealer" (section 4402(1)(B)) includes any affiliate of a registered broker or dealer, to the extent consistent with the Act, as determined by the Board.

The Board could expand the "financial institution" definition either by case-by-case determinations or by rule-making. The Board believes it would be appropriate to establish, by rule, a category of entities that may be considered financial institutions under the Act. The Board would retain the discretion to make individual determinations in cases where entities do not meet the rule's requirements for a financial institution, but where application of the Act's netting provisions to their transactions would reduce systemic risk and increase efficiency in the financial markets.[2]

Scope of the proposed rule. The Board believes that, consistent with the purposes of the Act, the netting provisions of the Act should extend to all financial market participants that regularly enter into financial contracts, both as buyers and sellers, where the failure of the participant could create systemic problems in the financial markets. The failure of a significant market participant to meet its obligations at the end of the day could have serious systemic consequences in terms of losses to counterparties or market confidence and liquidity. The Board considered limiting coverage to institutions that are regulated by the federal or state government, that are affiliated with a defined financial institution, or that have a specific type of corporate charter. However, the Board believes that broad netting coverage would further the Act's goals to enhance efficiency and decrease systemic risk in the financial markets.

Market participants generally manage counterparty risk by setting bilateral exposure limits vis-a-vis other market participants. These limits may be influenced by a counterparty's affiliation, charter, or regulatory status. In some cases, these limits may constrain activity, particularly for participants that act as intermediaries and provide liquidity to the market. Extending the Act's netting provisions broadly to market obligations would allow participants to engage in more transactions within a given set of credit limits because those limits would be applied to the net, rather than the gross, amount of exposure to individual counterparties (including clearinghouses). Therefore, broader netting coverage would tend to loosen constraints on intermediaries, thereby enhancing market liquidity and reducing counterparty risk. Market participants could increase their gross transactions while maintaining the same or reducing exposure to bilateral credit risk. Accordingly, the Board believes that it is appropriate to extend netting coverage broadly to achieve enhanced liquidity and decreased risk in the financial markets. Market participants could then use their own judgment to account for a counterparty's affiliation charter, or regulatory status when setting bilateral credit limits.

Furthermore, a test based on regulatory status, affiliation, or class of charter may foster presumptions about the risks posed by market participants covered by the test. For example, tying netting to a particular regulatory status may lead market participants to conclude that regulated entities are less risky than unregulated entities. In practice, such a conclusion may prove unwarranted. The Board also believes that an extension of the Act's coverage should be competitively neutral, if possible, in its effects on existing and potential financial market participants who may benefit from the increased liquidity and reduced systemic risk resulting from greater certainty about netting arrangements.

In addition, "regulated entity," "affiliation," and "charter" tests could be both over- and under-inclusive. For example, extending coverage only to government-regulated entities could exclude major unregulated market participants, such as swap dealers that are affiliates of securities broker-dealers, while at the same time covering entities that are regulated but that engage in little or no financial market activity that would benefit from netting. Similarly, applying an "affiliation" or "charter" test could exclude major market participants that are not affiliated with financial institutions or that lack a specific type of charter and could include marginal-to-inactive market participants. Thus, the Board believes that a "regulated entity," "affiliation," or "charter" test would be inappropriate.

Proposed rule. The proposed rule is designed to allow certain participants in markets for financial contracts, other than depository institutions, broker-dealers, and futures commission merchants (which are already covered by the Act), to receive the benefits of the Act's netting provisions. The proposal sets out a two-prong test for market participants, one regarding the nature its market activity and one regarding the volume of its activity, to determine whether it qualifies as a "financial institution" under the Act.

To meet the first prong of the test, a person must actively participate in a financial market for its own account and hold itself out as a counterparty that will engage in transactions both as a buyer and a seller in one or more financial markets (hereinafter such a person will be referred to as a "dealer"). A financial market is a market for a financial contract, which, in turn, means a "qualified financial contract" as defined in the Federal Deposit Insurance Act.[3] A "person" means any legal entity, including a corporation, unincorporated company, partnership, government unit or instrumentality, natural person, or any similar entity or organization.

A dealer must hold itself out to the market (such as through advertisements or company reports or by setting two-way price quotes) as an intermediary who will enter into transactions both as a buyer and seller in the market. For example, a dealer would offer either to make fixed-rate payments or to receive fixed-rate payments in the market for fixed/floating interest rate swaps. A dealer must engage in market transactions for its own account, rather than as agent or fiduciary for its customers. A dealer normally would not receive a brokerage commission but rather would rely on favorable price spreads as compensation.

(i) In which all members other than the clearing organization itself are financial institutions or other clearing organizations; or

(ii) Which is registered as a clearing agency under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*); or

(B) That performs clearing functions for a contract market designated pursuant to the Commodity Exchange Act (7 U.S.C. 1 *et seq.*).

[2] The Board has already made individual determinations in the cases of three participants in the New York Clearing House Interbank Payments System (CHIPS). The three participants (American Express Bank Ltd., French American Banking Corporation, and Banesto Banking Corporation) do not meet the Act's definition of financial institution, but the Board determined that they may be considered financial institutions under the Act's netting provisions for purposes of their participation in CHIPS. In making this determination, the Board considered the substantial payments volume that flows through CHIPS, the steps taken to achieve settlement finality for CHIPS, and the systemic consequences of a CHIPS settlement failure.

[3] 12 U.S.C. 1821(e)(8)(D). For purposes of the definition of "qualified financial contract," the definition of a forward contract includes a spot contract (a contract with a maturity of 2 days or less).

A dealer must be engaged in the business of dealing on a regular basis, but dealing need not be its primary business activity. For example, a non-financial corporation may qualify as a dealer if it actively participates in the swaps or foreign exchange markets, even though the focus of its primary business may be unrelated to the financial markets. Such a corporation, which would maintain a "professional" market presence and would regularly receive solicitations from other market participants, is distinguishable from an "end-user," which may enter into certain types of financial contracts on a recurring basis but does not actively deal on both sides of the market.

The size of a dealer's financial market activity must be large enough to have the potential to cause systemic risk problems should it fail to settle for its obligations. As the second prong of its test, the Board has set threshold levels on financial market activities that a dealer must meet in order to be considered a financial institution for purposes of the Act. To satisfy the quantitative test, a dealer must:

(1) Have outstanding one or more financial contracts of a total gross dollar value of $1 billion in notional principal amount on any day during the previous 15-month period, with counterparties that are not its affiliates, or

(2) Have incurred total gross mark-to-market positions in one or more financial contracts of $100 million on any day during the previous 15-month period with unaffiliated counterparties.[4]

Once a market participant meets both prongs of the test, it would be considered a financial institution for the next 15 months. Any netting contract, as defined in section 402(14) of the Act, that the participant enters into during the period when it qualifies as a financial institution would be eligible for coverage under the Act's netting provisions.

The Board requests comment on whether the quantitative thresholds are too high or too low. The lower the thresholds, the greater the number of dealers that can qualify for netting, and the easier it will be for relatively large dealers to prove their netting qualifications to counterparties. Many institutions, such as small banks and credit unions, already qualify for netting under the terms of the Act, even though they would not meet the quantitative thresholds in the proposed rule. The Board would reexamine whatever thresholds it sets if market practice demonstrates that the thresholds are giving certain small institutions a competitive advantage. For example, small-volume market participants that qualify as financial institutions by virtue of the Act's definition could take advantage of the Act's netting provisions and therefore could gain a potential competitive advantage over small-volume dealers that are not covered by the Act and cannot meet the rule's quantitative thresholds.

To determine whether it is a financial institution on any given day, a dealer would apply the quantitative tests to financial contracts that it entered into during the previous 15 months. Under the proposed rolling 15-month period, a dealer could compile its trading data on an annual basis and, depending on the last date it met the threshold, could have as many as three additional months after the end of the annual reporting period to calculate the data. The Board requests comment on whether a longer or shorter period, or a fixed period such as a calendar year, would be appropriate.

There may be instances where a person engages in netting but does not qualify as a financial institution. Such a person may request that the Board, under its discretionary authority, determine that it is a financial institution. The request must include a statement as to how a determination that the person is a financial institution would enhance efficiency and reduce systemic risk in financial markets. The Board may certify such persons as financial institutions for general purposes (*e.g.*, for all types of netting contracts entered into by the institution) or for limited purposes (*e.g.*, for netting contracts within a certain clearing organization).

Initial Regulatory Flexibility Analysis

The Regulatory Flexibility Act (5 U.S.C. 601-612) requires an agency to publish an initial regulatory flexibility analysis with any notice of proposed rulemaking. Two of the requirements of an initial regulatory flexibility analysis (5 U.S.C. 603(b))—a description of the reasons why the action by the agency is being considered and a statement of the objectives of, and legal basis for, the proposed rule—are contained in the supplementary information above. There are no reporting provisions or relevant federal rules that duplicate, overlap, or conflict with the proposed rule.

Another requirement for the initial regulatory flexibility analysis is a description of, and where feasible, an estimate of the number of small entities to which the proposed rule shall apply. The proposed rule will apply only to entities with financial contracts of $1 billion in gross notional principle amount or gross mark-to-market positions of $100 million over a period of a year. Entities with a smaller level of market activity would not be covered by the Board's expanded definition of "financial institution." Many small market participants are included in the Act's definition of "financial institution" and thus are already covered by the netting provisions. The Board limited its expansion of the Act's definition to entities with a relatively large volume of activity because the lack of netting coverage for small entities is unlikely to affect overall market efficiency or systemic risk.

List of Subjects in 12 CFR Part 231

Banks, banking, Financial institutions, Netting.

For the reasons set out in the preamble, the Board proposes to add a new part 231 to Title 12, Chapter II of the Code of Federal Regulations to read as follows:

PART 231—NETTING ELIGIBILITY FOR FINANCIAL INSTITUTIONS

Sec.
231.1 Authority, purpose, and scope.
231.2 Definitions.
231.3 Qualification as a financial institution.

Authority: 12 U.S.C. 4402(1)(B) and 4402(9).

§ 231.1 Authority, purpose, and scope.

(a) *Authority.* This part (Regulation EE; 12 CFR part 231) is issued by the Board of Governors of the Federal Reserve System under the authority of sections 402(1)(B) and 402(9) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4402(1)(B) and 4402(9)).

(b) *Purpose and scope.* The purpose of the Act and this part is to enhance efficiency and reduce systemic risk in the financial markets. This part expands the Act's definition of "financial institution" to allow more financial market participants to avail themselves of the netting provisions set forth in sections 401-407 of the Act (12 U.S.C. 4401-4407). This part does not affect the status of those financial institutions specifically defined in the Act.

§ 231.2 Definitions.

As used in this part, unless the context requires otherwise:

(a) *Act* means the Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub. L. 102-242, 105 Stat. 2236), as amended.

[4] In effect, a dealer could meet the quantitative test on a "rolling" basis. A dealer would qualify as a financial institution for 15 months after the most recent day it met the quantitative test.

(b) *Affiliate*, with respect to a dealer, means any person that controls, is controlled by, or is under common control with the dealer.

(c) *Financial contract* means a qualified financial contract as defined in section 11(e)(8)(D) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)(D)), as amended, except that a forward contract includes a contract with a maturity date two days or less after the date the contract is entered into (*i.e.*, a "spot" contract).

(d) *Financial market* means a market for a financial contract.

(e) *Gross mark-to-market positions* in one or more financial contracts means the sum of the absolute values of positions in those contracts, adjusted to reflect the market values of those positions in accordance with the methods used by the parties to each contract to price the contract.

(f) *Person* means any legal entity, including a corporation, unincorporated company, partnership, government unit or instrumentality, natural person, or any similar entity or organization.

§ 231.3 Qualification as a financial institution.

A person qualifies as a financial institution for purposes of sections 401-407 of the Act if it—

(a) Participates actively in a financial market for its own account and holds itself out as a counterparty that will engage in transactions both as a buyer and a seller in the financial market; and

(b)(1) Had one or more financial contracts of a total gross dollar value of $1 billion in notional principal amount outstanding on any day during the previous 15-month period with counterparties that are not its affiliates; or

(2) Incurred total gross mark-to-market positions (aggregated across counterparties) in one or more financial contracts of $100 million on any day during the previous 15-month period with counterparties that are not its affiliates.

By order of the Board of Governors of the Federal Reserve System, May 13, 1993.

William W. Wiles,

Secretary of the Board.

[FR Doc. 93-11835 Filed 5-18-93; 8:45 am]

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