U.S. GOVERNMENT ACCOUNTABILITY OFFICE

**441 G St. N.W.
Washington, DC 20548**

B-329552

November 14, 2017

The Honorable Michael Crapo
Chairman
The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Jeb Hensarling
Chairman
The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives

Subject: *Federal Deposit Insurance Corporation: Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions*

Pursuant to section 801(a)(2)(A) of title 5, United States Code, this is our report on a major rule promulgated by the Federal Deposit Insurance Corporation (FDIC) entitled "Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions" (RIN: 3064-AE46). We received the rule on October 30, 2017. It was published in the *Federal Register* as a final rule on October 30, 2017. 82 Fed. Reg. 50,228.

According to FDIC, the final rule improves the resolvability of systemically important U.S. banking organizations and systemically important foreign banking organizations and enhances the resilience and the safety and soundness of certain state savings associations and state-chartered banks that are not members of the Federal Reserve System (state non-member banks or SNMBs) for which FDIC is the primary federal regulator (together, FSIs or FDIC-supervised institutions). The final rule requires that FSIs and their subsidiaries (covered FSIs) ensure that covered qualified financial contracts (QFCs) to which they are a party provide that any default rights and restrictions on the transfer of the QFCs are limited to the same extent as they would be under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Federal Deposit Insurance Act (FDI Act). In addition, covered FSIs are generally prohibited from being party to QFCs that would allow a QFC counterparty to exercise default rights against the covered FSI based on the entry into a resolution proceeding under the FDI Act, or any other resolution proceeding of an affiliate of the covered FSI. The final rule also amends the definition of "qualifying master netting agreement" in FDIC's capital and liquidity rules and certain related terms in FDIC's capital rules. These amendments are intended to ensure that the regulatory capital and liquidity treatment of QFCs to which a covered FSI is party would not be affected by the restrictions on such QFCs.

Enclosed is our assessment of FDIC's compliance with the procedural steps required by section 801(a)(1)(B)(i) through (iv) of title 5 with respect to the rule. Our review of the procedural steps taken indicates that FDIC complied with the applicable requirements.

If you have any questions about this report or wish to contact GAO officials responsible for the evaluation work relating to the subject matter of the rule, please contact Shirley A. Jones, Assistant General Counsel, at (202) 512-8156.

signed

Robert J. Cramer
Managing Associate General Counsel

Enclosure

cc: M. Andy Jiminez
Director, Office of Legislative Affairs
Federal Deposit Insurance Corporation

ENCLOSURE

REPORT UNDER 5 U.S.C. § 801(a)(2)(A) ON A MAJOR RULE
ISSUED BY THE
FEDERAL DEPOSIT INSURANCE CORPORATION
ENTITLED
"RESTRICTIONS ON QUALIFIED FINANCIAL CONTRACTS OF CERTAIN FDIC-SUPERVISED INSTITUTIONS; REVISIONS TO THE DEFINITION OF QUALIFYING MASTER NETTING AGREEMENT AND RELATED DEFINITIONS"
(RIN: 3064-AE46)

(i) Cost-benefit analysis

The Federal Deposit Insurance Corporation (FDIC) described the economic effects of the final rule as follows: The costs of the final rule are likely to be relatively small and only affect 11 covered FSIs. Only 8 of the 11 affected institutions had qualified financial contracts (QFCs) over the past 5 years. The QFC activity of those eight firms represented less than .02 percent of QFC activity among all FDIC-insured global systemically important banking organization (GSIB) subsidiaries. Covered FSIs and their counterparties may incur administrative costs associated with drafting and negotiating compliant QFCs. However, the rule only limits the execution of default rights for a brief time period in the event that a GSIB or GSIB affiliate enters a resolution process. Further, the rule only affects QFCs that contain default rights or transfer restrictions, so not all QFC activity will be affected by the rule. Affected institutions also have the option of adhering to the Universal Protocol or the U.S. Protocol as an alternative to amending QFCs, and they have a phase-in compliance period of up to 2 years to become fully compliant with the rule. The flexibility that the final rule allows for affected institutions and their counterparties further reduces the expected costs associated with this rule. Therefore, according to FDIC, costs associated with drafting compliant QFCs are likely to be low. In addition, FDIC anticipates that covered FSIs would likely share resources with their parent GSIB and/or GSIB affiliates—which are subject to parallel requirements—to help cover compliance costs. The stay-and-transfer provisions of the Dodd-Frank Act and the FDI Act are already in force, and the Universal Protocol is already partially effective for the 25 existing GSIB adherents. The partial effectiveness of the Universal Protocol (regarding section 1, which addresses recognition of stays on the exercise of default rights and remedies in financial contracts under special resolution regimes, including in the United States, the United Kingdom, Germany, France, Switzerland, and Japan) suggests, as stated by FDIC, that to the extent covered FSIs already adhere to the Universal Protocol, some implementation costs will likely be reduced.

According to FDIC, the final rule could potentially impose costs on covered FSIs to the extent that they may need to provide their QFC counterparties with better contractual terms in order to compensate those parties for the loss of their ability to exercise default rights. These costs may be higher than drafting and negotiating costs. However, they are also expected to be relatively small because of the limited reduction in the rights of counterparties and the availability of other forms of credit protection for counterparties. The final rule could also create economic costs by causing a marginal reduction in QFC-related economic activity. FDIC does not expect any significant reduction in QFC activity to result from this rule. Counterparties are also able to prudently manage risk through other means, including entering into QFCs with entities that are not GSIB entities and therefore would not be subject to the final rule.

FDIC further states the following: The final rule will likely benefit the counterparties of covered FSIs by preventing the disorderly failure of the GSIB subsidiary and enabling it to continue to meet its obligations. The mass exercise of default rights against an otherwise healthy covered FSI resulting from the failure of an affiliate may cause it to weaken or fail. Therefore, preventing the mass exercise of QFC default rights at the time the parent or other affiliate enters resolution proceedings makes it more likely that the subsidiaries will be able to meet their obligations to QFC counterparties. Moreover, the creditor protections permitted under the rule will allow any counterparty that does not continue to receive payment under the QFC to exercise its default rights, after any applicable stay period. As stated by FDIC, because financial crises impose enormous costs on the economy, even small reductions in the probability or severity of future financial crises create substantial economic benefits. FDIC also states in the rule that QFCs play a large role in the financial markets and are a major source of financial interconnectedness, and, therefore, they can pose a threat to financial stability in times of market stress. It also states that the final rule will materially reduce risk to the financial stability of the United States that could arise from the failure of a GSIB by enhancing the prospects for the orderly resolution of such a firm, and would thereby reduce the probability and severity of financial crises in the future. According to FDIC, the final rule will also likely benefit the Deposit Insurance Fund (DIF). Mass exercise of QFC default rights by the counterparties at the time the parent or other affiliate of an FDIC-insured institution enters resolution could lead to severe losses for, or possibly the failure of, FDIC-insured subsidiaries of failed GSIBs. Those losses and/or failures could result in considerable losses to the DIF.

(ii) Agency actions relevant to the Regulatory Flexibility Act (RFA), 5 U.S.C. §§ 603-605, 607, and 609

FDIC determined that this final rule will not have a significant economic impact on a substantial number of small entities.

(iii) Agency actions relevant to sections 202-205 of the Unfunded Mandates Reform Act of 1995, 2 U.S.C. §§ 1532-1535

As an independent regulatory agency, FDIC is not subject to the Act.

(iv) Other relevant information or requirements under acts and executive orders

Administrative Procedure Act, 5 U.S.C. §§ 551 et seq.

On October 26, 2016, FDIC published a proposed rule. 81 Fed. Reg. 74,326. FDIC received 14 comments on the proposed rule from banking organizations, trade associations, public interest advocacy groups, and private individuals. FDIC staff also met with some commenters at their request to discuss their comments on the proposal, and summaries of these meetings may be found on the FDIC's public website. FDIC discussed the comments in the final rule.

Paperwork Reduction Act (PRA), 44 U.S.C. §§ 3501-3520

According to FDIC, section 382.5 of the proposed rule contained a collection of information requirement within the meaning of PRA. OMB has assigned the following control number to this information collection: 3064-AE46. This information collection consists of amendments to covered QFCs and, in some cases, approval requests prepared and submitted to FDIC regarding modifications to enhanced creditor protection provisions (in lieu of adherence to the

International Swaps and Derivatives Association Protocol). Section 382.5(b) of the final rule would require a covered FSI to request FDIC to approve as compliant with the requirements of sections 382.3 and 382.4, provisions of one or more forms of covered QFCs or proposed amendments to one or more forms of covered QFCs, with enhanced creditor protection conditions. A covered FSI making a request must provide (1) an analysis of the proposal under each consideration of section 382.5(d); (2) a written legal opinion verifying that proposed provisions or amendments would be valid and enforceable under applicable law of the relevant jurisdictions, including, in the case of proposed amendments, the validity and enforceability of the proposal to amend the covered QFCs; and (3) any additional relevant information that FDIC requests.

Covered FSIs would also have recordkeeping associated with proposed amendments to their covered QFCs. However, much of the recordkeeping associated with amending the covered QFCs is already expected from a covered FSI. Therefore, FDIC states that it would expect minimal additional burden to accompany the initial efforts to bring all covered QFCs into compliance. The existing burden estimates for the information collection associated with section 382.5 are stated to be as follows: on occasion, six respondents will need to spend 40 hours per response, for a total of 240 burden hours.

Statutory authorization for the rule

FDIC promulgated this final rule under the authority of the FDI Act (12 U.S.C. 1811 et seq.).

Executive Order No. 12,866 (Regulatory Planning and Review)

As an independent regulatory agency, FDIC is not subject to the requirements of the Order.

Executive Order No. 13,132 (Federalism)

As an independent regulatory agency, FDIC is not subject to the requirements of the Order.