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FDIC and Treasury Officials Point to Derivatives as an Element of US Financial Regulatory Reform

In a recent public address, FDIC Chairman Sheila Bair announced that her agency will soon consider issuing a proposed rule to set recordkeeping requirements for troubled institutions regarding their qualified financial contracts (QFCs), and will seek comment on setting minimum QFC recordkeeping requirements for all FDIC-insured institutions. The following day, Treasury Secretary Henry Paulson publicly addressed the need for broader reform of the US financial regulatory structure, in which he emphasized the need to strengthen the infrastructure for trading over-the-counter derivatives. Even if this combination of events was merely a coincidence, it suggests that increased regulatory attention to derivatives is likely for banks and nonbanks alike.

QFCs are defined in the Federal Deposit Insurance Act (FDIA) to include a broad array of securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements as well as any similar agreements identified by the FDIC. The FDIA recognizes the special role that QFCs play for banks, as both end-users and as dealers, and for intermediation in the financial markets as a whole. To that end, the FDIC must decide how it will handle all QFCs at a failed bank within one business day after it is appointed as receiver or conservator, and it must make a single, collective decision with regard to all QFCs entered into with a given counterparty and the affiliates of that counterparty, in order to preserve netting arrangements.

These requirements put a severe burden on the FDIC when it is appointed receiver or conservator, because it must assemble and review information on all QFCs held by a failed institution and must understand the purpose for which those QFCs are held before it can make an informed decision how to proceed. Depending on the type of QFC and its purpose, this information may be dispersed among several trading desks, various operating divisions and separately incorporated affiliates, and what records there are may not be uniform. While the practice of enterprise-wide risk management may suggest that all QFCs held by a bank and its affiliates would be identified and regularly evaluated, such practices may vary. Moreover, the FDIC has discovered, as it has prepared for potentially more frequent bank failures, that the use of QFCs has grown substantially among smaller and less sophisticated organizations.

Chairman Bair indicated that the FDIC's initial QFC proposal will require detailed recordkeeping only for institutions in troubled condition. This designation may not encompass the depository institutions with the largest derivatives contracts exposures or that are most important to the market before it is too late to put the information to use for supervisory purposes. To address this concern, Chairman Bair also announced that the FDIC will seek public comment whether all depository institutions should be subject to minimum recordkeeping requirements for their derivatives portfolios.

Secretary Paulson also addressed the need for more information about QFCs traded over-the-counter, but for a different supervisory purpose. He was not concerned about the FDIC's specific needs, but he focused on a similar set of information. In order to combat the perception that certain institutions are too big or too interconnected to fail, he stated that the operating procedures in the OTC derivatives market (and the tri-party repo system) must be made more transparent and more robust, and that the procedures for winding down or resolving OTC derivatives positions must be clarified.

The devil is always in the details, but it would not be surprising to find that the FDIC's efforts to standardize QFC recordkeeping at banks serve as a template for broader reforms of the kind outlined by Secretary Paulson. Enhanced recordkeeping for QFCs and OTC derivatives as sketched out by the regulators is not intended to affect the products or pricing that banks and nonbanks provide, but the compliance burden may have the secondary yet substantive effect of encouraging standardization. This may effect where the users of derivatives contracts will find the most responsive counterparties, the most innovative products and the best pricing. The high-profile statements from the FDIC and Treasury suggest that all financial institutions that participate in the US derivatives market should pay attention to the FDIC's forthcoming QFC recordkeeping proposals.

Authors and Contributors

For more information regarding this client alert, please contact your usual Fried Frank attorney or any of the attorneys listed below:

Washington, DC

Thomas P. Vartanian
+1.202.639.7200

David L. Ansell
+1.202.639.7011

Robert H. Ledig
+1.202.639.7016

Gordon Miller
+1.202.639.7173

Fried, Frank, Harris, Shriver & Jacobson LLP

New York
One New York Plaza
New York, NY 10004-1980
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC
1001 Pennsylvania Avenue, NW
Washington, DC 20004-2505
Tel: +1.202.639.7000
Fax: +1.202.639.7003

Frankfurt
Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555

Hong Kong
in association with
Huen Wong & Co.
9th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
Tel: +852.3760.3600
Fax: +852.3760.3611

Shanghai
No. 888 Wanhangdu Road
7th Floor, Unit D
Shanghai 200042
(until Summer 2008, when we will be located in
Park Place, Nanjing Road West)
Tel: +86.21.2321.0188
Fax: +86.21.6326.6899

Fried, Frank, Harris, Shriver & Jacobson (London) LLP

London
99 City Road
London EC1Y 1AX
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Fried, Frank, Harris, Shriver & Jacobson (Europe)

Paris
65-67, avenue des Champs Elysées
75008 Paris
Tel: +33.140.62.22.00
Fax: +33.140.62.22.29