

Stay What?!!

*A primer on the ISDA 2018 US Resolution
Stay Protocol*

NAPCO Credit Conference

March 5, 2019

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OPTION 1

If, prior to the date of this Agreement, both parties hereto have executed an Agreement to Amend Certain Qualified Financial Contracts or a bilateral agreement which amends one or more QFCs between them in a manner consistent with the QFC Stay Rules (such applicable agreement, the “Bilateral Agreement”), the terms of the Bilateral Agreement shall be incorporated into and form a part of this Agreement. For purposes of incorporating the Bilateral Agreement, each party shall be deemed to have the status of “Covered Entity” or “Counterparty Entity” (as such terms are defined therein) applicable to it under the Bilateral Agreement and this Agreement shall be deemed to be a “Covered Agreement” (as defined therein).

OPTION 2

If, prior to the date of this Agreement, both parties hereto have adhered to the ISDA 2018 U.S. Resolution Stay Protocol, as published by the International Swaps and Derivatives Association, Inc. as of July 31, 2018 (the “ISDA U.S. QFC Protocol”), the terms of the ISDA U.S. QFC Protocol shall be incorporated into and form a part of this Agreement. For purposes of incorporating the ISDA U.S. QFC Protocol, each party shall be deemed to have the same status as “Regulated Entity” and/or Adhering Party (as such terms are defined therein) applicable to it under the ISDA U.S. QFC Protocol and this Agreement shall be deemed to be a “Protocol Covered Agreement” (as defined therein).

Today's Goal:

To understand where these provisions are coming from and how they can be addressed

Genesis: the 2008 financial crisis



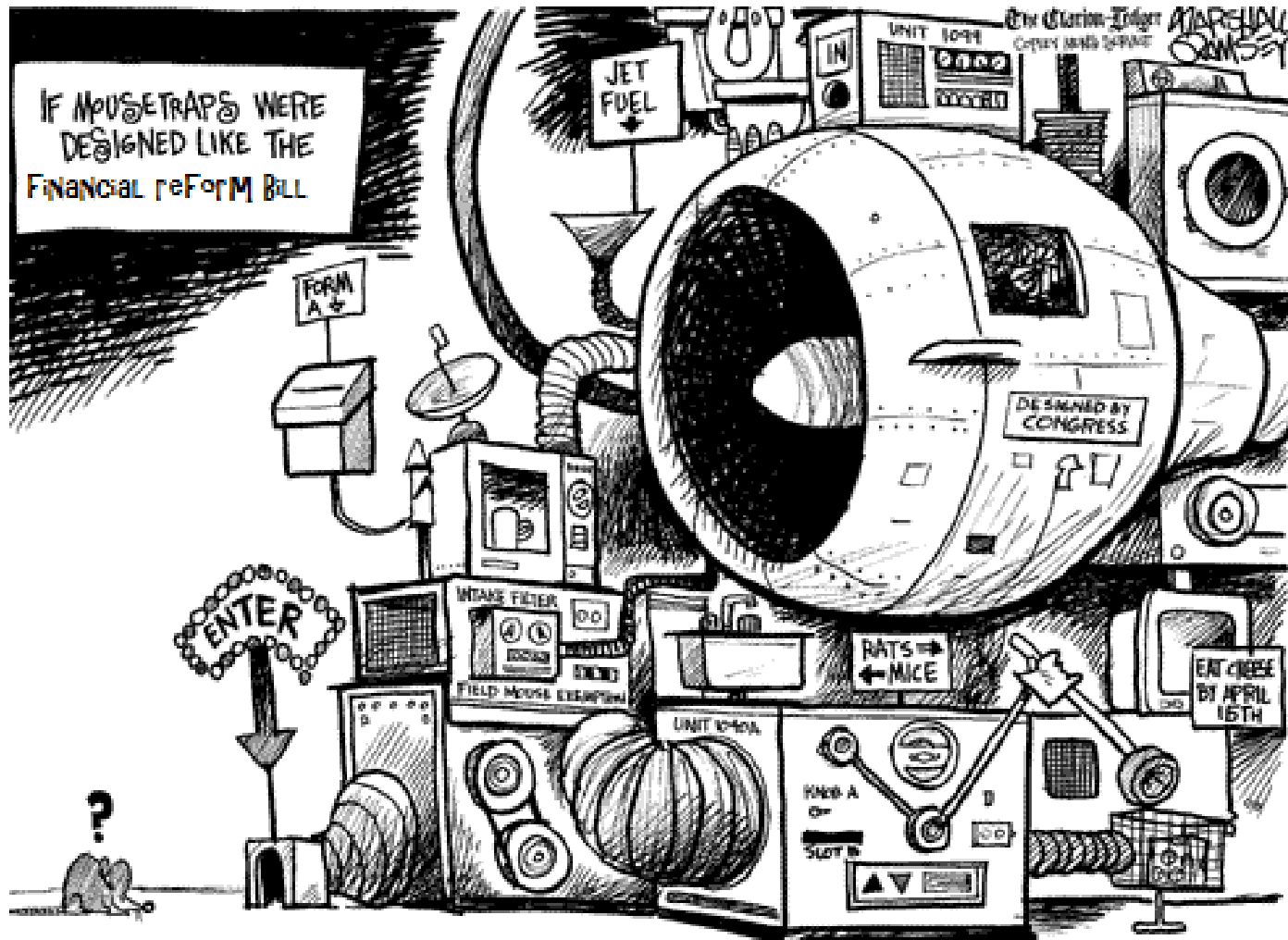
The 2008 financial crisis

- We saw the failure, or equivalent failure, of:
 - Bear Stearns
 - IndyMac Bank
 - Lehman Brothers
 - Washington Mutual
 - Wachovia
 - Fannie Mae
 - Freddie Mac
 - AIG
- These entities had a collective \$4.7 trillion in assets at the beginning of 2008

The 2008 financial crisis

- Lack of resources and authority
 - “I will maintain to my deathbed that we made every effort to save Lehman, but we were just unable to do so because of a lack of legal authority.” (Ben Bernanke, Fed Chair, in 2009)
- Avoiding “too big to fail”
- Lehman-specific
 - There’s a need to avoid runs on banks
 - There’s a need to avoid moral hazard
- There’s a need to contain risk
- International comity

2010 – Dodd-Frank Wall Street Reform and Consumer Protection Act



Orderly Liquidation Authority

- Following the financial crisis, Congress saw fit to adopt a special resolution regime, dubbed the “orderly liquidation authority” (OLA) to address the insolvency of a systemically important financial institution (SIFI)
 - “This would not, by any definition, be a ‘bailout.’ Instead, it would be a financial funeral, an orderly funeral overseen by the FDIC – but a corporate death, nevertheless.” (Sheila Bair, Head of the FDIC, in 2017)
- Key aspects of the OLA:
 - Designation of SIFIs
 - The FDIC can be appointed (by the Treasury Secretary in consultation with the Fed) as receiver for a systemically important financial institution

The US Special Resolution Regime

- Ensures that a looming failure is handled expeditiously
- Management is removed
- Stockholders and creditors bear the losses
- FDIC has broad authority to arrange for the sale of selected assets, arrange for the acquisition of the relevant entity, or create a bridge financial company
 - Temporary funding can be provided if necessary
 - Protected under law by a priority claim on the failing firm's assets and, if necessary, by assessments on other SIFIs
 - Employs a "single point of entry" model
- Early termination rights are temporarily stayed

The QFC Rule

The QFC Rule

- In 2017, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the FDIC adopted regulations that require certain global systemically important banks to include specific provisions in their non-cleared qualified financial contracts
- The rules are substantively the same
- Effectively amounts to the regulation of non-GSIBs by contract

Global Systemically Important Banks (i.e., regulated entities for purposes of the QFC Rule)

| U.S. GSIBs | Foreign GSIBs |
|--|---|
| Bank of America Bank of New York Mellon Citigroup Goldman Sachs JP Morgan Chase Morgan Stanley State Street Wells Fargo | Agricultural Bank of China Bank of China Barclays BNP Paribas China Construction Bank Credit Suisse Deutsche Bank Group BPCE Groupe Credit Agricole HSBC Industrial and Commercial Bank of China Limited ING Bank Mitsubishi UFJ FG Mizuho FG Royal Bank of Canada Santander Societe Generale Standard Chartered Sumitomo Mitsui FG UBS Unicredit Group |

QFCs

- The term “qualified financial contract” is very broadly defined
- Means any securities contract, commodity contract, forward contract, repurchase agreement swap agreement and any similar agreement that the FDIC determines to be a QFC
- Master agreements that cover any of these types of contracts are also considered QFCs
- Guarantees, credit enhancements, security agreements, and reimbursement obligations that relate to QFCs are also considered QFCs

QFC Rule Requirements – Section 1

- Requires US GSIBs, the foreign operations of US GSIBs, and the US operations of foreign GSIBs, to obtain a contractual opt-in to the US special resolution regime
- The opt-in must stipulate that:
 - A transfer from the regulated entity will be effective to the same extent as the transfer would be effective under the US special resolution regime if the QFC were governed by US law
 - The counterparty's default rights may be exercised against the regulated entity to no greater extent that such default rights could be exercised under the US special resolution regime if the QFC were governed by US Law
- Does not apply to QFCs with US persons that are governed by US law

QFC Rule Requirements – Section 2

- Cross-default that is related, directly or indirectly, to an affiliate of the regulated entity becoming subject to receivership, insolvency, liquidation, resolution or similar proceeding, is prohibited
- A QFC may not prohibit the transfer of a “credit enhancement” that has been provided by the affiliate or the regulated entity that is a direct party to the QFC
- A “credit enhancement” is a guarantee, letter of credit, or other form of credit support

QFC Rule Requirements – Section 2 (cont.)

– Exemptions:

- The regulated entity that is a direct party to the QFC itself
 - Becomes insolvent or enters into resolution, or
 - Fails to satisfy any payment or delivery obligation pursuant to the QFC or another contract between the same parties that gives rise to the default right under the QFC
- The provider of the credit enhancement fails to satisfy a payment or delivery obligation under the credit enhancement

QFC Rule Requirements – Section 2 (cont.)

- Additional creditor protections for QFCs that benefit from a credit enhancement:
 - The original provider of the credit enhancement, or its transferee, becomes subject to a receivership, insolvency, liquidation, resolution or similar proceeding
 - The credit enhancement transferee does not remain or become obligated to the same, or substantially similar, extent as the original credit support provider was immediately prior to entering into resolution
 - All of the ownership interests in the regulated entity are not transferred to the credit enhancement transferee
 - Reasonable assurance has not been provided that all or substantially all of the assets of the original credit support provider will be transferred or sold to the credit enhancement transferee

Compliance Dates

| Compliance Date | Applicable to |
|------------------------|--|
| January 1, 2019 | QFCs between regulated entities |
| July 1, 2019 | QFCs between regulated entities and financial counterparties other than small financial institutions |
| January 1, 2020 | QFCs between regulated entities and all other counterparties, including small financial institutions |

— Caveats:

- If a regulated entity wishes to engage in QFCs with counterparties on or after January 1, 2019, then such QFC must comply with the QFC Rule
- The compliance requirements of the QFC Rule are triggered any time a regulated entity or one of its affiliates enters into any QFC with a counterparty or its affiliates
- Affiliation is based on whether entities have consolidated financials

The ISDA 2018 US Resolution Stay Protocol

What is a “protocol”?

- A tool that can be used to amend existing QFCs
- Does not require negotiation
- Amends all QFCs that an adherent to the Protocol has in place with other adherents to the Protocol (assuming that one counterparty is a regulated entity for purposes of the QFC rule)
- Adherence consists of completing and submitting a signed letter to ISDA and the payment of a \$500 fee

The ISDA 2018 US Resolution Stay Protocol

- Tracks the structure of the QFC rule
 - Section 1 serves as an opt-in to the US special resolution regime as well as the special resolution regimes of France, Germany, Japan, Switzerland and the UK
 - Section 1 does not apply to QFCs that are governed by US law between a regulated entity and a US person
 - Section 2 tracks the overall requirements of the QFC Rule. It provides that:
 - An adherent may not exercise any cross-default rights under a QFC with a regulated entity arising from an affiliate of the regulated entity entering into resolution
 - Limits the ability of an adherent to exercise its default rights under a QFC related to the provider of a credit enhancement becoming insolvent or entering into resolution

Enhanced Creditor Protections

- The Protocol offers additional protections to creditors in respect of affiliate cross default than are offered under the QFC Rule
- Specifically, it contains a broader list of conditions that must be satisfied by a credit enhancement provider guarantee:
 - Any guarantees provided by a failing regulated entity must be transferred to a healthy bank; otherwise, those claims must be given administrative status in insolvency proceedings, with priority over unsecured creditors.
 - If these conditions are not met within 24 hours, or 48 hours if the resolution takes place over a weekend, the stay is lifted and counterparties can exercise their cross-default rights
- Guarantees provided with bilateral arrangements do not need to be given administrative status, and their stays will only be lifted if the resolution effort fails and the regulated entity's guarantees or assets are not transferred to a solvent entity within 48 hours

Key Considerations

- Not limited to derivatives
- The QFC Rule expressly recognizes the Protocol as a safe harbor
 - If a regulated entity does not adhere to the Protocol, or if its counterparties do not adhere to the Protocol, the regulated entity must address the QFC Rule's requirements on a bilateral basis and make a determination that such alternative method satisfies the QFC Rule's requirements
- Cannot be incorporated by reference without adherence
- Revocation is possible, but only on a going-forward basis

Alternatives to the ISDA 2018 US Resolution Stay Protocol

Bilateral Amendments

- Market participants are not required to use the Protocol and can instead amend their existing QFCs on a bilateral basis
- ISDA has published forms that can be used as a starting point
- Pros:
 - More tailored approach
 - Document control
 - Not limited to the QFC Rule
- Cons:
 - Time consuming
 - Costly
 - Not a safe harbor, so less certainty and clarity
 - Fewer creditor protections

IECA Bilateral Amendments

- Revises ISDA bilateral amendments to more closely track regulatory requirements
- Provide guidance to ensure that market participants take the necessary steps to avoid potential default
- Key items:
 - Scope of the amendment – covered agreements and counterparties
 - Consents and representations necessitate due diligence
 - Ensure compliance with non-QFC Rule regulatory requirements (e.g., utility regulatory requirements)

“Compliance does not mean acquiescence.”*

- Central clearing
- Trading with smaller dealers
- Material adverse change clauses
- Ratings downgrade triggers

*RISK.net, *Buy-siders eye ways to get ahead of US resolution stay rules*, 19 Feb 2019

Foreign Special Resolution Regimes

Other countries have laws too!

- Europe: the Bank Recovery and Resolution Directive
 - ISDA 2016 Bail-in Art 55 BRRD Protocol (two versions) – covers bail-in
 - ISDA Resolution Stay Jurisdictional Modular Protocol (JMP) – same coverage as ISDA 2018 US Resolution Stay Protocol, but consists of various jurisdiction-specific modules and affords some flexibility on scope
- Japan: Comprehensive Guidelines issued by the Japanese Financial Services Agency
 - ISDA JMP
- Switzerland: Banking Ordinance of the Swiss Federal Council
 - ISDA JMP

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