Client Alert

Bank Advisory/Capital Markets

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Deferral of the Swaps Push-Out Requirement, But Only for Insured Federal Depository Institutions

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An insured federal depository institution may request a transition period to comply with the "push-out" requirements of section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") according to guidance issued by the Office of the Comptroller of the Currency ("OCC") on December 31, 2012 ("Guidance").[1] Insured federal depository institutions granted a transition period will be allowed for a time—but not beyond July 16, 2015—to defer compliance with the requirement to conduct swaps activities in a separate entity in order to continue to qualify for access to the Federal Reserve discount window and other funding programs sponsored by the US government. Requests for a transition period are to be made in writing to the OCC by January 31, 2013.

The Guidance derives from section 716 of the Dodd-Frank Act that allows the appropriate federal banking supervisor to provide "an insured depository institution that qualifies as a ''swaps entity'' and would be subject to the federal assistance prohibition" a transition period of up to 24 months to divest its swaps entity or cease the activities that require registration as a swaps entity.[2] That provision also allows for the grant of an additional one-year extension on top of the "up to 24-month" initial extension, but that is not part of the Guidance.

Guidance Key Points

Eligibility
Only national banks, federal savings associations and federally licensed US branches of foreign banking organizations ("FBOs") that are insured under the Federal Deposit Insurance Act are eligible to request a transition period. The Guidance does not apply to other swaps entities directly supervised by the OCC, including uninsured federally licensed US branches and agencies of FBOs. The Guidance also does not apply to any state-chartered banks, savings associations or branches and agencies of FBOs, whether insured or not.

Applicability
Only insured federal depository institutions that are or plan to become swaps entities engaged in nonconforming activities may be granted a transition period (provided that, as discussed below, entities that are unsure of their status as swap entities may also request relief). The Guidance specifies that insured federal depository institutions presently engaged only in conforming swap activities are not eligible for a transition

1 The Guidance is available on the OCC website at http://www.occ.treas.gov/news-issuances/news-releases/2013/nr-occ-2013-2a.pdf.

2 Dodd-Frank Act §716(f).

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period as these conforming activities are not covered by the section 716 prohibition on federal funding. Conforming activities are those set out in section 716(d) and cover (i) hedging and similar risk mitigating activities directly related to the bank's activities and (ii) swaps involving rates or reference assets that are permissible for investment by a national bank under the National Bank Act (12 US C §24(Seventh), other than non-cleared credit default swaps (including swaps referencing the credit risk of asset-backed securities).

One-Time Request

The Guidance contemplates a one-time request for a transition period of up to two years. Eligible insured federal depository institutions must submit a request by January 31, 2013. The Guidance does not provide for submission of requests after that deadline notwithstanding that the swaps "push-out" rule is not effective until July 16, 2013.

Swap Dealer Status

The Guidance provides that an insured federal depository institution that is "unsure" of whether or when it may become a swaps entity may request a transition period. The OCC requires a request in such cases to include an explanation of why the institution believes that it may be or will become a swap dealer or security-based swap dealer.

Request Contents

The Guidance provides that requests for a transition period must be in writing and include a discussion of the plan to conform swap activities and how the transition period will mitigate the adverse consequences to the areas listed in section 716, including mortgage lending, small business lending, job creation, capital formation, insured depositors and the insurance fund. The request must also specify the duration of the transition period that is appropriate for the institution (i.e., up to two years commencing on July 16, 2013), the extent to which the requested transition period could have a negative impact on the institution's insured depositors and the FDIC's Deposit Insurance Fund, any operational risks and other safety and soundness concerns that a transition period would mitigate, and other facts that the institution believes the OCC should consider.

Observations

The OCC did not apply the Guidance to uninsured federal branches or agencies that are under direct OCC supervision.

This is interesting, as the Guidance finds a transition period "warranted" for a number of important reasons that would seem to apply to swaps entities whether or not insured. The OCC notes that required compliance with section 716 would be premature given that the Title VII regulatory framework of the Dodd-Frank Act remains incomplete and to the extent that regulations are being phased-in does not leave sufficient time to negotiate and amend master swap agreements to allow for conformance by the statutory effective date of July 16, 2013. The Guidance finds that premature compliance could result in potential disruptions to client services, operational and credit risks and the inability to make well-informed determinations on business restructurings. The OCC is mindful that a transition period is necessary to avoid these "unwanted adverse consequences." The silence on the treatment of uninsured branches and agencies is all the more disconcerting given the Guidance emphasis on the "unwanted adverse consequences" of premature compliance.

The OCC does not discuss whether the limited application of the Guidance is based on a strict reading of the statute or a finding that broader application is not justified. Arguments for the latter have been presented to the federal banking supervisors. These include:

- The clarification offered in a colloquy between the push-out provision's author and the sponsor of the Dodd-Frank Act that the omission of uninsured branches and agencies from the push-out exemption was a drafting oversight and not Congressional intent
- If the section 716 prohibition even applies to uninsured entities
- The unclear language of the section 716 prohibition that can be read narrowly to limit access to government funding only if used in connection with swaps activities
- The application of a separate entity doctrine to allow that swaps activities conducted by the FBO outside of its US branches and agencies would not trigger the section 716 prohibition on government funding

The other federal banking supervisors did not participate with the OCC in issuing the Guidance.

By contrast, guidance on defining July 16, 2013 as the effective date of section 716 was issued jointly by the OCC, the Board of Governors of the Federal Reserve System ("Board") and the Federal Deposit Insurance Corporation ("FDIC"). The two latter agencies have not indicated if state member and nonmember banks and state-licensed branches and agencies, whether insured or not, will be given a similar opportunity to request a transition period. Absence of the availability of a transition period would leave state chartered or licensed insured and uninsured depository institutions, like uninsured federal branches and agencies, facing the unwanted adverse consequences cited by the OCC.

It will be interesting to see if the Board and the FDIC allow for a transition period and, if so, how expansively they define the banking entities entitled to such relief. Keeping in mind that the purpose of section 716 is to prohibit taxpayer funding of swaps activities, there would seem to be little purpose in not applying a uniform transition period to all banking entities. The Guidance will allow the largest swaps and security-based swap dealers—national banks estimated by the OCC to control the lion's share of outstanding notional swap values—continued access to the discount window and other government funding despite their continued direct conduct of nonconforming swaps activities. There would seem little potential risk or potential cost to taxpayers in allowing state-chartered insured depository institutions that same continued access to the discount window and other government funding. There too would seem to be little risk in extending the transition period to uninsured branches and agencies of FBOs, though they are not insured depository institutions.