

Regulatory brief

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Resolution preparedness: Do you know where your QFCs are?

Overview

In January, the US Secretary of Treasury issued a notice of proposed rulemaking (“NPR”) that would establish new recordkeeping requirements for Qualified Financial Contracts (“QFCs”).¹ US systemically important financial institutions (“SIFIs”) and certain of their affiliates² will be required under the NPR to maintain specific information electronically on end-of-day QFC positions, and to be able to provide this information to regulators within 24 hours if requested. This is a significant expansion in both scope and detail from current QFC recordkeeping requirements, which now apply only to certain insured depository institutions (“IDIs”) designated by the FDIC.³

When a company enters insolvency (either through bankruptcy or FDIC receivership), an automatic stay is triggered that generally prohibits creditors and counterparties from terminating, offsetting against collateral, or taking any other mitigating action with respect to their outstanding contracts with the insolvent company. However, under US law counterparties to QFCs are exempt from this stay and may usually begin to exercise their contractual rights after the close of business the next day.⁴ In case of receivership, the FDIC must decide within this time period whether to transfer the QFC to another institution, retain the QFC and allow the counterparty to terminate it, or repudiate the QFC and pay out the counterparty.

The NPR is intended to help the FDIC with this decision by making available detailed information on a failed company's QFCs, given the FDIC's expanded receivership powers under Dodd-Frank's Orderly Liquidation Authority (“OLA”). As a practical matter, to be of meaningful assistance to the FDIC and meet the NPR's requirements, we believe impacted entities will have to have the ability to *report this information on a daily basis* (which is essentially needed in order to produce the data within 24 hours).

It is noteworthy that Treasury issued the NPR, instead of the six regulators that Dodd-Frank charged with jointly doing so (i.e., FDIC, Fed, OCC, SEC, CFTC, and FHFA). It is likely that the regulators were unable to agree on the substance of the NPR or on the importance of timely completing it, which is why the Treasury Secretary acted.⁵ We would expect some change to the NPR upon finalization, as regulators attempt to achieve consensus in response to the public comments that will likely be submitted (the NPR asks 75 questions impacting many entities); the NPR's scope may be somewhat narrowed to focus on entities more likely to be subjected to OLA.

This **Regulatory brief** provides our analysis of the NPR and its key challenges, and our view of what institutions should be doing now. The Appendix details the NPR's requirements.

¹ QFCs include securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements. Master agreements that cover one or more of these types of contracts as well as securities agreements, guarantees, credit enhancements, or reimbursement obligations that relate to QFCs are also considered to be QFCs under the NPR.

Key challenges

The NPR generally requires that entities maintain (and link) position, collateral, and legal agreement data for bilateral, exchange-traded, and centrally cleared QFCs, and for certain QFC-related financing transactions (e.g., extensions of credit for the purchase or sale of securities). In addition, institutions must obtain and keep certain counterparty information (e.g., organizational structure, contact information, and pre- and post-trade documentation), as well as other information that is not specified under the NPR but must otherwise be reported to a swap data repository in the US or abroad.

These requirements bring a wide range of business units (e.g., sales and trading, financing, and custody operations) and activities within the NPR's scope, which for many institutions will necessitate reconsideration of how products are booked across various legal entities and jurisdictions. The following are three key challenges to meeting the NPR's requirements.

QFC data must be centralized and normalized

At many institutions, the data needed to meet the NPR's requirements must be sourced from a large number of different systems and applications, which often use different definitions and identifiers for the same data. These variances necessitate normalization, especially for data that must be centralized such as customer contact information, which is a significant challenge especially for those institutions with substantial FX and custody activities. Ultimately, standardized reporting of this data would provide regulators with a better view of activities and systemic risks posed by financial institutions, both individually and as a group.

Unique counterparty and agreement identifiers must be created and incorporated into systems that capture QFC exposures

Institutions must maintain unique identifiers for all legal entities with which they enter QFCs (including their own affiliates), and use the same identifier across all QFC activities. Since these counterparty identifiers must be aligned with legal entity identifiers ("LEI"), institutions may be able to leverage on-going LEI implementation projects and their existing counterparty on-boarding processes to meet the NPR's requirements. Implementation will nevertheless be challenging, particularly for institutions with multiple legacy systems that use different identifiers to classify the same counterparty. Utilizing unique identifiers consistently for both counterparties and the institution's affiliates will allow for the efficient aggregation (and reporting) of QFC exposures and their associated collateral and documentation.

Legal agreements associated with QFC activities must be archived in an electronic and searchable format

Firms will need to centralize and catalogue agreements, and convert agreements maintained only in paper form into a searchable electronic format. This is particularly challenging for QFCs that are guaranteed or supported by the institution and its covered affiliates, given that such contracts are numerous and often geographically dispersed throughout the institutions' network of affiliates. This effort will facilitate compliance with other requirements of the NPR as well, including generating automated reference sheets of documents associated with QFCs (see Table A3 in the Appendix of this brief), and automated tagging of certain contractual provisions (e.g., non-standard covenants included in ISDA contracts).

² These SIFIs include bank holding companies and savings and loan holding companies with over \$50 billion in assets, and nonbank and financial market utilities designated as systemically important by the Financial Stability Oversight Council. See PwC's *Regulatory briefs, Financial market utilities: Is the system safer?* (February 2015) and *Nonbank SIFIs: FSOC proposes initial designations* (June 2013). Notably, the NPR does not apply to IDIs but does generally apply to SIFIs' other subsidiaries including swap dealers, broker-dealers, and futures commission merchants.

³ See 12 CFR part 371, *Recordkeeping Requirements for Qualified Financial Contracts*, which implemented section 11(3)(8)(H) of the Federal Deposit Insurance Act. We expect the FDIC's current rule governing FDIC-designated "troubled" IDIs to eventually be made consistent with the NPR's heightened requirements.

⁴ However, counterparties subject to agreements such as the International Swaps and Derivatives Association (ISDA) Protocol would generally not be able to exercise such remedies as terminating, offsetting against collateral or taking any other action with respect to their outstanding contracts. Similarly, counterparties whose QFCs with a failed institution are transferred to a bridge entity or to another financial institution by the FDIC in its capacity as receiver would not be able to terminate or exercise other remedies on such contracts due to the insolvency.

⁵ Dodd-Frank granted the Secretary of the Treasury the authority to issue the NPR if the rulemaking was not completed by the regulators by July 21, 2012.

What should institutions be doing now?

Impacted institutions will want to respond the NPR's call for public comments, due by April 7, 2015, especially given the broad swath of entities that will be impacted – some of which are less likely than others to be ultimately subjected to the FDIC's OLA.⁶ The 75 questions can be broadly categorized into the following key areas:

- Determining the appropriate universe of entities and activities that should be included in the final rule's scope (or exempted from it), considering factors such as size, business purpose, and jurisdiction.
- Assessing whether affiliated entities should report their data in aggregate or separately.
- Considering whether reporting should be customized based on certain entities' business activities (e.g., for financial market utilities), and by different transaction types (e.g., bilateral versus centrally cleared), or complement other reporting that may or could be available to the FDIC as receiver.
- Identifying the optimal reporting requirements for inter-affiliate transactions.

Meeting the NPR's requirements will necessitate an enterprise-wide initiative and strong executive support, as entities will need more resources and clear organizational ownership for compliance. Given the short window of time to act once the rule is finalized (less than a year, according to the NPR), financial institutions should now:

- Identify legal entities within the organization that would be subject to the recordkeeping/reporting requirements;
- Identify impacted QFCs that exist across the organization;
- Assess the systems that will be used for reporting and the flow of key system data that is necessary for next-day reporting; and
- Understand the current data gaps vis-à-vis the NPR's requirements.

Although taking these steps will require extensive coordination across the institution's business lines, operations and IT, we believe these potentially significant investments and increased capabilities will help the institution beyond just meeting the NPR's requirements. As key examples, this identification and assessment of QFC data will assist risk-management processes, and recovery and resolution planning efforts.

⁶ The European Banking Authority (EBA) recently proposed similar regulatory requirements for QFC recordkeeping. Impacted institutions may wish to consider the requirements of and aligning their NPR comments with a possible response to the EBA's proposal. See EBA's *Draft Regulatory Technical Standard on a minimum set of the information on financial contracts that should be contained in the detailed records* (March 6, 2015).

Appendix: QFC reporting requirements

The NPR requires four separate reports focusing on trade level (A1), counterparty level (A2), collateral detail (A3), and legal agreements (A4). This Appendix provides a summary of the required contents for these forms, and of other requirements around the format, availability, and maintenance of QFC records.

Content of QFC reports

Table	Requirements
A1 Report: <i>Position-level for all QFC positions</i>	<ul style="list-style-type: none">• Booking information<ul style="list-style-type: none">– Desk/business description and identifier– Contact name and information of the person responsible for the position• Position information<ul style="list-style-type: none">– Unique position identifiers (e.g., CUSIP, trade identifier, etc.)– Counterparty identifier, name, and industry code– Type of position (e.g., interest rate swap, repurchase agreement, etc.)– Purpose of the position (e.g., trading or hedging)– Currency– Notional value– Market value– Issue, termination, cancellation, and next call/put dates– GAAP classification• Trade documentation<ul style="list-style-type: none">– Position status (i.e., confirmed, affirmed, or open)– Master agreement supporting counterparty relationship, form, and identifier reference– Related position identifiers
A2 Report: <i>Counterparty-level aggregated exposure</i>	<ul style="list-style-type: none">• Counterparty exposure<ul style="list-style-type: none">– Market value of exposures– Market value of collateral posted/received– Collateral excesses/deficiencies– Collateral thresholds– Market value of inter-affiliate positions• Counterparty information<ul style="list-style-type: none">– Identifier, name, and industry code– Contact information (including name, email address, and phone number)• Documentation information<ul style="list-style-type: none">– Each applicable master agreement's name and unique identifier– Risk manager name and contact information
A3 Report: <i>Information on QFC-related legal agreements</i>	<ul style="list-style-type: none">• Agreement name and reference number• Agreement form and governing law• Default information<ul style="list-style-type: none">– Cross-default– Transfer restrictions– Termination events– Custom EODs and ATEs– Removed standard EODs and ATEs• Guarantees (entity and counterparty)<ul style="list-style-type: none">– Guarantee agreement reference number– Legal name and identifier of the guarantor• Counterparty information<ul style="list-style-type: none">– Name, Identifier and Industry Code– Contact information (including name, email address, and phone number)

Table	Requirements
A4 Report: <i>Detailed collateral information supporting the A2 report</i>	<ul style="list-style-type: none"> • CUSIP identifier for collateral • Counterparty name and identifier • Original face and current market values • Description of collateral • Collateral code for aggregation • Master agreement name and identifier • Collateral location, jurisdiction, and ability to re-hypothecate • Master netting agreement name and identifier

Key requirements for QFC recordkeeping

Area	Requirements
Document retention	<ul style="list-style-type: none"> • Maintain records for all QFCs to which the entity is a party, including inter-affiliate QFCs. • Maintain records for all QFCs for which the entity provides a guarantee or support. • All legal agreements governing QFC transactions must be maintained in a fully searchable electronic form, capable of generating data in the format required for Tables A-1 through A-4. • All documents must be capable of being transmitted electronically to regulators.
Counterparty identifier and affiliate listings	<ul style="list-style-type: none"> • Maintain a list of all affiliates of the entity that are parties to QFCs and organizational charts that explain affiliate relationships. • The affiliate listing must specify which affiliates are counterparties to inter-affiliate QFC exposures of the entity. • Include a list of all unique counterparty identifiers and organizational charts that explain the affiliate relationships between counterparties. • The unique counterparty identifiers must be consistent with global LEIs.
Organizational information	<ul style="list-style-type: none"> • Identify the entity's point of contact primarily responsible for compliance with QFC requirements. • Identify risk metrics used to monitor the QFC portfolio and risk manager contact information for each impacted business area. • Maintain a list of vendors who directly support QFC activities, including their contact information.

Additional information

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