Swaps Pushout Rule: OCC Prepared to Grant Two-Year Transition Period to Federal Insured Depository Institutions

January 7, 2013

The OCC has published long-awaited **guidance** notifying federally-chartered insured depository institutions ("**IDIs**") that it is prepared to grant applications to delay compliance with Section 716 of the Dodd-Frank Act (the "**Swaps Pushout Rule**") for up to two years.[1] The Swaps Pushout Rule will become effective on July 16, 2013. A federally-chartered IDI[2] must submit a formal request for a transition period to the OCC by January 31, 2013. The content of such requests is discussed further below.

We believe that the Federal Reserve and the FDIC will issue similar guidance to state-chartered IDIs subject to their primary supervision. But it remains to be seen whether such guidance will address the application of the Swaps Pushout Rule to uninsured U.S. branches and agencies of foreign banks.

Overview of the Swaps Pushout Rule, Its Implications and Uncertainties

Controversial Provision: The Swaps Pushout Rule has been one of the most controversial provisions of the Dodd-Frank Act. It was opposed by the heads of all three federal banking agencies[3] as well as Paul Volcker.[4] Both Federal Reserve Chairman Ben Bernanke and former FDIC Chairman Sheila Bair said it would increase systemic risk, rather than reduce it.[5] The Swaps Pushout Rule has not improved with age. Indeed, one of the key lessons from the preparation of resolution plans under Title I of the Dodd-Frank Act, and recent simulations of the resolution of a systemically important financial institution under Title II of the Dodd-Frank Act,[6] is that pushing swaps out of insured banks into non-bank affiliates creates an impediment to the orderly resolution of banking groups.

When swaps are held within an insured bank, their value can be preserved for the benefit of the bank's creditors (including the FDIC's Deposit Insurance Fund) and the stability of the financial system because the FDIC has the statutory power and incentive to transfer the swaps to a creditworthy third party or bridge bank within one business day after the original bank's failure, overriding any otherwise applicable rights of counterparties to terminate the swaps. In contrast, counterparties have the right to immediately terminate swaps held within a non-bank affiliate under the Bankruptcy Code, and bankruptcy courts have no power or incentive to override those rights by transferring the contracts to a creditworthy third party or

[1] A Davis Polk memorandum summarizing the Swaps Pushout Rule is available **here**.

[2] Federally-chartered IDIs include national banks, federal savings associations and insured federal branches of foreign banks.

[3] *See* Letter from Ben Bernanke, Federal Reserve Chairman, to Senator Christopher Dodd (May 13, 2010), available **here**; Letter from Sheila Bair, FDIC Chairman, to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), available **here**; Remarks by John Dugan, then Comptroller of the Currency, at the Thomson Reuters Global Financial Regulation Summit 2010 (Apr. 27, 2010).

[4] *See* Letter from Paul Volcker, former Federal Reserve Chairman, to Senator Christopher Dodd (May 6, 2010), available **here**.

[5] *See* Letter from Ben Bernanke, Federal Reserve Chairman, to Senator Christopher Dodd (May 13, 2010), available **here**; Letter from Sheila Bair, FDIC Chairman, to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), available **here**.

[6] *See, e.g.*, American Banker, The Inside Story of How the Clearing House Proved Dodd-Frank Works (Dec. 19, 2012), available **here**.

bridge company. Selective termination of swaps by a bankrupt entity's counterparties typically results in the sort of value destruction and severe market disruption that occurred in the Lehman bankruptcy. As a result, there have been numerous efforts since the enactment of the Swaps Pushout Rule in July 2010 to repeal or significantly modify it.[7]

What Does the Swaps Pushout Rule Do? By its terms, the Swaps Pushout Rule prohibits any federal assistance from being provided to "swaps entities," including registered swap dealers, security-based swap dealers, major swap participants and major security-based swap participants.[8] Federal assistance includes FDIC deposit insurance and access to the Federal Reserve's discount window. This means, for example, that a bank that registers as a swap dealer will be ineligible for deposit insurance or access to the Federal Reserve's discount window *unless* the bank "pushes out" its swap dealing activities to non-bank affiliates that are not eligible for deposit insurance or access to the Federal Reserve's discount window, or ceases to engage in such swaps activities altogether, subject to any applicable exemption or transition period.

Exemption and Transition Period: The Swaps Pushout Rule contains an exemption that allows an "insured depository institution," a term that is *not* defined in Section 716 of the Dodd-Frank Act,[9] to engage in swaps used to hedge or mitigate risk and swaps involving rates or national bank-eligible assets (*e.g.*, interest rate swaps and swaps that reference currencies, bullion metals, loans or bank-eligible debt securities), other than uncleared credit default swaps.[10] The Swaps Pushout Rule also authorizes the appropriate U.S. banking agency, after consulting with the CFTC and the SEC, to provide an "insured depository institution" a transition period of up to 2 years, which can be extended by one additional year, to cease any non-exempt swap activities.

Uncertainty for Foreign Banks: A significant number of foreign banks that have registered or will soon register as swaps entities operate branches or agencies in the United States that are not eligible for deposit insurance, but that have access to the Federal Reserve's discount window.[11] At present, there is significant uncertainty regarding the impact of the Swaps Pushout Rule on such foreign banks.

According to former Senator Blanche Lincoln, the principal author of the Swaps Pushout Rule, and former Senate Banking Committee Chairman Christopher Dodd, the Swap Pushout Rule's failure to expressly extend the insured depository institution exemptions and transition period provisions to the uninsured U.S. branches and agencies of foreign banks was an "unfortunate and clearly unintended" legislative

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[7] *See, e.g.*, Swaps Bailout Prevention Act, H.R. 1838, available **here**.

[8] IDIs are excluded from the definition of "swaps entity" if they are major swap participants or major security-based swap participants.

[9] *But see, e.g.*, Federal Deposit Insurance Act, Section 3(c).

[10] This exemption was added to the Swaps Pushout Rule as a last-minute attempt to mitigate its impact. The bifurcation between exempt and non-exempt swaps, however, creates difficulties with respect to hedging and the simplification of legal entities within financial institutions and would, as a practical matter, either require an institution to push out all swaps or ask counterparties to deal with multiple legal entities.

[11] Approximately half of the 65 entities that provisionally registered with the CFTC as swap dealers as of December 31, 2012 are affiliated with foreign banks. As of September 30, 2012, there were approximately 182 uninsured state and federally licensed branches of foreign banks with aggregate assets of $1,936 billion; 46 uninsured state and federally licensed agencies of foreign banks with aggregate assets of $164 billion; and 10 grandfathered insured state and federally licensed branches of foreign banks with aggregate assets of $68 billion. *See* Federal Reserve, Structure and Share Data for U.S. Banking Offices of Foreign Entities (Sept. 2012), available **here**.

"oversight."[12] It remains to be seen, however, whether the U.S. banking agencies will remedy this oversight through rulemaking or interpretative guidance. It also remains to be seen whether the U.S. banking agencies, particularly the Federal Reserve, which is responsible for the overall supervision and regulation of the U.S. operations of foreign banks, will look to the separate entity doctrine in interpreting and applying the Swaps Pushout Rule.

Separate Entity Doctrine: Applying the separate entity doctrine, U.S. federal and state courts and banking agencies have treated branches of foreign banks as legally separate entities that are separate from the bank as a whole and separate from each other branch for purposes of many U.S. banking and non-banking laws and regulations.[13] In the Swaps Pushout Rule context, reliance on this doctrine could mean, for example, that a U.S. branch of a foreign bank that has access to the Federal Reserve's discount window could comply with the Swaps Pushout Rule without giving up such access, by pushing any swap dealing activity into a separate U.S. or non-U.S. branch that does not have access to the discount window. Applying the separate entity doctrine to the Swaps Pushout Rule is consistent with the fact that discount window access is granted on a branch-by-branch basis and not to the foreign bank as a whole or to its non-U.S. branches.[14]

Content of Requests for a Transition Period

In order to obtain a transition period, a federally-chartered IDI must submit a formal request to the OCC by **January 31, 2013**. The OCC stated that it is prepared to consider such requests favorably, provided that the requests conform to the guidance provided below. A federally-chartered IDI that is unsure whether it will become a swaps entity may also request a transition period so long as the IDI explains why it believes it might be or become a swaps entity.

All transition period requests to the OCC must discuss:

- The institution's plan for conforming its swaps activities;
- How the requested transition period would mitigate adverse effects on mortgage lending, small business lending, job creation, and capital formation;
- 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;
- 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.

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[12] *See* 156 Cong. Rec. S5903-S5904 (daily ed. Jul. 15, 2010) (Colloquy between Senator Christopher Dodd, Chairman of the Senate Banking Committee, and Senator Blanche Lincoln, Chairman of the Senate Agriculture Committee and sponsor of the Swaps Pushout Rule).

[13] *See* Cleary Gottlieb Steen & Hamilton LLP, Davis Polk & Wardwell LLP and Sullivan & Cromwell LLP, White Paper on the Separate Entity Doctrine as Applied to the U.S. Branches of Foreign Headquartered (Non-U.S.) Banks (Apr. 19, 2012), available **here**.

[14] The separate entity doctrine was also applied to another type of federal assistance: FDIC deposit insurance. Before the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991, FDIC deposit insurance coverage for U.S. branches of foreign banks was granted on a branch-by-branch basis so that a foreign bank could have a branch in one U.S. state that was insured by the FDIC and another branch in another U.S. state that was not insured by the FDIC. *See* 12 C.F.R. § 347.203.

The OCC may require a requesting federally-chartered IDI to provide additional information before granting a transition period. The OCC may impose such conditions on a transition period as it deems necessary and appropriate.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Luigi L. De Ghenghi	212 450 4296	luigi.deghenghi@davispolk.com
Susan C. Ervin	202 962 7141	susan.ervin@davispolk.com
Randall D. Guynn	212 450 4239	randall.guynn@davispolk.com
Arthur S. Long	212 450 4742	arthur.long@davispolk.com
Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Lanny A. Schwartz	212 450 4174	lanny.schwartz@davispolk.com
Margaret E. Tahyar	212 450 4379	margaret.tahyar@davispolk.com
Andrew S. Fei	212 450 4063	andrew.fei@davispolk.com
E. Ashley Harris	212 450 4780	ashley.harris@davispolk.com
Gabriel D. Rosenberg	212 450 4537	gabriel.rosenberg@davispolk.com

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