Transcript of Open Board Meeting
May 3, 2016

CHAIR YELLEN. Good afternoon and welcome to our guests who are attending or watching our meeting. The proposed rules we are considering today are important elements of the Board's strategy to ensure that our financial system remains strong and stable enough to support the economy through both good times and bad.

The first proposal we will consider today is crafted to strengthen the resiliency of large banking organizations and thereby reduce the chance that they might fail. The financial crisis proved that an overreliance on unstable funding sources, particularly short-term wholesale funding, leaves firms vulnerable to liquidity risk and poses serious threats to financial stability. This proposal would establish the Net Stable Funding Ratio--or NSFR. This ratio would require large banking organizations to maintain a minimum amount of stable funding tailored to the different risk profiles of these firms and based on a one-year time horizon. By requiring our largest institutions to maintain an amount of stable funding that is appropriate given the liquidity of their assets, the NSFR would strengthen the financial system, making it more resilient to market stress.

The second proposal supports our strategy to reduce the potential systemic impact of the failure of a large, interconnected banking organization. The crisis underscored that when a large financial institution gets into trouble, its failure can destabilize other firms. This is because large banking organizations are connected with each other by the business they do together and through the contracts that result from that business. Indeed, in the 21st century, a run on a failing banking organization may begin with the mass cancellation of the derivatives and repo contracts that govern the everyday course of financial transactions. When these contracts, known collectively as Qualified Financial Contracts or QFCs, unravel all at once at a failed large

banking organization, an orderly resolution of the bank may become far more difficult, sparking asset firesales that may consume many firms.

That is why we are considering a proposal that would require very large banking organizations to use contracts that allow for a limited stay in resolution so that there is time to transfer QFCs from a failed firm to a solvent one. This stay-and-transfer requirement will help manage the risk when a very large firm fails, and will thus strengthen the resiliency of the financial system as a whole.

Let me now turn to Governor Tarullo who led the effort to develop these two proposals.

GOVERNOR TARULLO. So, Madam Chair, we're going to go one after the other here, so I should just do the introduction to the NSFR?

CHAIR YELLEN. Yes, we're going to start with the NSFR.

GOVERNOR TARULLO. OK. So thank you, Madam Chair.

The financial crisis, which at least in the first instance was a liquidity crisis, drew attention to the need for quantitative liquidity regulation, which had been essentially non-existent. The proposed Net Stable Funding Ratio (NSFR) has been developed as a complement to the Liquidity Coverage Ratio (LCR), which we have already adopted and is now applicable to large U.S. banking organizations.

The LCR's thirty-day scope addresses the most immediate and acute liquidity problems that large firms could encounter in a period of stress. The NSFR, as the Chair has already noted, requires these firms to maintain a stable funding profile over a one-year time horizon, thereby mitigating the potential effects of a firm's loss of funding and creating strong incentives for firms to extend the maturity of their funding arrangements. In addition, because of the impact that a withdrawal of funding from the customers of large firms can have on the financial system during

periods of stress, the proposal requires more stable funding for short-term loans to other financial firms.

As with all liquidity regulation, the proposal must require firms to maintain sustainable funding profiles and to avoid inappropriate reliance on central bank liquidity access. At the same time it should not incentivize firms to horde liquidity in periods of stress, rather than to use it to keep the financial system operating. I look forward to comments from the public both on how successfully the proposal balances these objectives and on what other regulatory and supervisory measures might help achieve these regulatory aims.

And let me now turn to Mike Gibson to introduce the staff presentation.

MICHAEL GIBSON. Thank you, Governor Tarullo.

The Federal Reserve has been comprehensively strengthening its regulatory and supervisory framework for large banking organizations since the financial crisis. The proposed NSFR the Board is considering today is another important and significant step forward.

As Governor Tarullo noted, the NSFR would be the second quantitative liquidity requirement issued by the Board, the first being the liquidity coverage ratio, or LCR. The LCR focuses on resilience to short-term liquidity stress. The NSFR compliments the LCR by requiring large financial firms to maintain stable funding based on a longer one-year time horizon. These quantitative requirements augment other aspects of the Federal Reserve's liquidity risk oversight framework, including our liquidity stress testing and other supervisory standards.

Under our supervisory framework, the Federal Reserve conducts regular horizontal examinations of both qualitative and quantitative aspects of liquidity risk at our largest and most complex firms. The comprehensive liquidity analysis and review, known as CLAR, provides a

comprehensive view of liquidity risk management and stress testing practices of firms that are overseen by our Large Institution Supervision Coordinating Committee, or LISCC.

The Federal Reserve also conducts different and tailored horizontal assessments of liquidity risk at other firms with $50 billion or more in total assets. These horizontal reviews allow our supervisors to benchmark across supervisory portfolios, identify outliers, and help form a more complete view of liquidity vulnerabilities and funding concentrations in the system as a whole. The NSFR would be an important addition to this framework by establishing a standardized quantitative minimum stable funding requirement.

In terms of implementation, banking organizations that would be subject to the proposed rule have already made significant gains since the financial crisis in strengthening the resilience to funding disruptions. A number of factors have contributed to these gains, including regulations that indirectly improve the stability of firm funding profiles, the Federal Reserve supervisory oversight and stress testing efforts, anticipation by firms of U.S. implementation of the NSFR, and market discipline since the financial crisis. The NSFR proposal would require firms to maintain these gains going forward, reinforcing the safely and soundness of the firms, and improving the resilience of our financial system to liquidity stress.

Staff estimates that nearly all subject firms would meet the proposed NSFR requirement if it were in effect today. The estimated stable funding shortfall across all firms is approximately $40 billion or about one half of 1 percent of the aggregate requirement. Based on these current shortfall estimates, we do not expect firms to incur a significant cost to come into compliance by the proposed January 2018 effective date and do not expect significant cost to maintain compliance going forward.

I will now turn to Adam Trost for a more detailed description of the proposed net stable funding ratio.

ADAM TROST. Thank you, Director Gibson.

The proposal the Board is considering today is a result of a team effort across divisions here at the Board and the U.S. federal banking agencies. The proposed NSFR would be issued jointly with the FDIC and the OCC. My colleagues, including Kevin Littler, Adam Cohen, and Brian Chernoff, will help you answer your questions following my prepared remarks.

The 2007-2009 financial crisis exposed the vulnerability of large financial institutions to liquidity shocks. During the crisis, these firms experienced severe contractions in their supply of funding. As access to funding became limited and asset prices fell, many firms faced the possibility of failure. This threat caused governments and central banks around the world to provide significant levels of support to the financial system to maintain global financial stability. The experience of the financial crisis demonstrated a need to address this vulnerability to liquidity shocks by implementing a more rigorous approach to measuring, monitoring, and limiting of firm's reliance on the less stable sources of funding.

The proposal would establish a quantitative liquidity requirement, the net stable funding ratio, which is designed to strengthen the ability of a firm to withstand disruptions to its regular sources of funding without compromising its liquidity position or contributing to instability in the financial system. Whereas the liquidity coverage ratio is a stress metric that requires a firm to hold a sufficient amount of high-quality liquid assets to survive a 30-day period of significant stress, the NSFR is a structural balance sheet metric that requires a firm to maintain a stable funding profile based on the liquidity of its assets over a one-year time horizon. In effect, the NSFR would limit the ability of a firm to fund illiquid assets with short-term unstable funding.

Under the requirement, a firm's available stable funding would be the numerator of the net stable funding ratio. A firm would calculate its available stable funding using standardized weighting referred to as ASF factors. These ASF factors represent the extent to which an equity instrument or liability is considered stable based on the likelihood a firm would need to repay or replace the funding over a one-year time horizon. ASF factor would be scaled from 0 to 100 percent, with a high ASF factor indicating more stability and a low ASF factor indicating less stability. For example, the proposed rule would assign fully insured retail deposits an ASF factor of 95 percent compared to an ASF factor of 0 percent for short-term funding from financial firms.

A firm's required stable funding would be the denominator of its net stable funding ratio. It would be the sum of two parts, one based on a firm's assets and funding commitments other than derivatives and the other based on a firm's derivatives. A firm would calculate the required stable funding for its non-derivative assets and funding commitments using standardized weightings referred to as RSF factors. Like the ASF factors, the RSF factors will be scaled from zero to 100 percent. A low RSF factor would indicate an asset is more liquid and would require less stable funding, and a high RSF factor would indicate an asset is less liquid and would require a more stable funding. For example, the proposed rule would assign U.S. treasury securities an RSF factor of 5 percent compared to an RSF factor of 85 percent for most long-term corporate and commercial real-estate loans.

A firm would separately calculate its required stable funding relating to its derivatives and portfolio, taking into account margin requirements and potential future changes in the value of the portfolio. The proposed rule would require a firm's net stable funding ratio to meet or

exceed 100 percent, meaning that it's the firm's available stable funding would need to meet or exceed its required stable funding.

The proposed rule would address the risk of trap liquidity within a consolidated banking firm. Trap liquidity exists when a firm appears to have a stable funding profile on a consolidated basis when in fact liquidity in one part of the firm is not available throughout the organization due to transfer restrictions. To address this risk and prevent an overstatement of a firm's NSFR, the proposed rule would allow a consolidated NSFR to include a subsidiary's excess available stable funding only if the subsidiary can transfer liquidity throughout the holding company without restriction. This approach to addressing trap liquidity is similar to the approach taken in the U.S. LCR.

The proposed rule would apply to the same large and internationally active firms that are subject to the LCR. Specifically the full NSFR would apply to U.S. bank holding companies and certain savings and loan holding companies that have total consolidated assets of $250 billion or more or $10 billion or more in on-balance sheet foreign exposure. The full NSFR requirement would also apply separately to banks with $10 billion or more in total consolidated assets that are subsidiaries of these holding companies.

Like the LCR, the proposed rule would include a tailored modified NSFR that would apply to U.S. bank holding companies and certain savings loan holding companies with $50 billion or more in total consolidated assets, but are not subject to the full NSFR requirement. The modified NSFR would apply to firms that are smaller, less systemically risky and generally less complex in structure than firms that would be subject to the full NSFR. Because of this lower level of risk, the proposed rule would require a modified NSFR firm to maintain an amount of

stable funding equivalent to 70 percent of the amount that would be required if the firm were subject to the full NSFR.

The proposed rule would not apply to holding companies with less than $50 billion in total consolidated assets and would not apply to community banks. The proposed rule would also not apply to non-bank financial companies designated by the Financial Stability Oversight Council for Board supervision. However, the Board would retain flexibility to apply the proposed rule in the future to these non-bank financial companies by a separate rule or order after assessing their business models and risk profile.

In addition, the proposed rule would not apply to the combined U.S. operations of foreign banking organizations. Staff intends to prepare a separate proposal for the Board's consideration in the future that will apply an NSFR and LCR to foreign banking organizations with significant U.S. operations.

As I noted earlier in my remarks, the NSFR requirement is designed to strengthen the ability of a firm to withstand disruptions to its regular sources of funding without compromising its liquidity position or contributing to instability in the financial system. However, it is of course possible that a firm could breach the minimum requirements. The proposal would retain flexibility for the Board to determine an appropriate supervisory response to a violation based on the particular facts and circumstances. Though the proposal provides for a flexible supervisory response to NSFR shortfalls, it would require a firm to give timely notice of a shortfall to the Board, and develop and submit to the Board a plan for remedying the firm's shortfall.

Lastly, the proposal would require a holding company subject to the rule to publicly disclose its NSFR and certain components of its NSFR in a standardized format on a quarterly basis. The proposed rule would also require a holding company to include a qualitative

discussion of its NSFR, which is meant to facilitate a better understanding of the firm's NSFR results. These standardized disclosures would promote market discipline by enabling market participants to compare U.S. firms subject to the proposed rule and firms subject to similar stable funding requirements and other jurisdictions. The proposed NSFR would become effective on January 1, 2018, which should provide firms a sufficient time to make adjustments to their funding structures and to their systems.

This concludes my prepared remarks. My colleagues and I would be pleased to answer any questions you may have.

CHAIR YELLEN. Thank you very much.

I just have one question for you. I wanted to ask you about two separate sources of liquidity risks for GSIBs. The first you mentioned in your presentation, derivatives; the second is matched book repo transactions. And I guess my question is, can you explain in a little bit more detail how the NSFR would address these liquidity risks? And then also, in light of that answer, do you think these rules will have significant impacts on activity or pricing in those markets?

ADAM TROST. So I can start by discussing derivatives. Due to complexity of derivatives, the proposed rule has a separate framework to address the funding risks associated with these transactions. The NSFR would have--deal with three distinct risks. The first aspect would require a firm to maintain stable funding based on the aggregate current value of a firm's derivatives portfolio. The second aspect would require a firm to maintain stable funding based on the collateral and future payments based on future--potential future declines in the derivatives--a firm's derivatives portfolio. The third aspect would require a firm to maintain stable funding based on initial margin the firm has posted based on its derivative transactions, and then also default fund contributions to central counterparties based on its clear derivatives. You know, we

look forward to public comment on whether we've captured all the risks with derivatives and the complexity of derivatives. And we also look forward to public comment on whether we've calibrated them appropriately.

MARK VAN DER WEIDE. And I'll address your matched book repo question. One of the ways in which the NSFR is a very useful supplement to the LCR, and this was referred to by Governor Tarullo in his opening remarks, is that it does have a charge for matched-book repo. We felt like this was one of the missing elements of the LCR. The LCR generally assumes that a very large book of matched book repo can be unwound pretty seamlessly in a very short period of time. We don't think that's a reasonable assumption. We think there are pretty good microprudential and macroprudential reasons for thinking there ought to be some kind of a regulatory charge for these matched-repo books.

So what the NSFR does is it deals with these risks by imposing a 10 to 15% stable funding charge on those transactions. We think that's a pretty appropriate level of charge to deal with both the funding risk to the firm and the financial stability risk. The funding risk is primarily one where firms often have very strong reputational incentives to maintain their lending to many of their clients, even if they're losing funding on the repo side. They will have incentives, naturally, to keep some of those reverse repos funding their clients. So I think there are those microprudential reasons to think there should be a charge. And we also think there are financial stability concerns. Just if the firm does come under stress, you know, the unwind of that repo book, if it's large, it's going to be something that's fairly disruptive for the financial markets. So we feel like there ought to be something around it, a 10 to 15 percent charge for these matched repo books.

We've tried to calibrate it in a way that was appropriate. We think by calibrating it relatively low, in the 10 to 15 percent range, we've calibrated it reasonably well. We try to create a little bit of gradation--not a lot, but a little bit of gradation between Treasury repos, which get the lower 10 percent RSF, and other repo, which get the higher 15% RSF. But in light of the relatively low levels of the RSF requirements here--which, by the way, can be met with more equity funding, more long-term debt funding, and even more insured deposit funding at a relatively cheaper form of funding--that we struck the balance right. We do see comment, though, in the proposal as to whether we had struck that balance right and we look forward to comment on the proposal going forward. We don't think it's going to be terribly impactful on the repo markets as they exist today. As Mike indicated earlier, the firms have more or less adapted to the NSFR already and you know, marginal adaptations that we don't think will have any severe impact, material impact.

CHAIR YELLEN. Thank you very much. Governor Tarullo?

GOVERNOR TARULLO. No questions, thank you.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. So, Adam, you mentioned the effect on liquidity, I think, in your presentation, and we hear quite a bit about liquidity and regulations and the impact of our regulations on liquidity, and we're very mindful of that. Can you say anything about what we expect the possible effect of the NSFR would be on market liquidity?

MICHAEL GIBSON. Sure, I can get that question. So, we observed that currently, the firms that would be subject to the proposed NSFR have very small shortfalls, so the marginal impact of closing those shortfalls and market liquidity should be minimal. Now, we would also want to look at how the regulation would affect market liquidity across the cycle and we believe

that, because the NSFR has a moderating effect across the cycle--that is, in boom times, having required stable funding will tend to moderate the boom, and in bad times, the stable funding will be available to support liquidity.

So, the impact on market liquidity similarly ought to be to smooth out the peaks and troughs of the cycle, and by removing or reducing the risk that a firm will find itself in a liquidity squeeze in a downturn, market liquidity and stress should be more available. But as we've answered in response to the other questions, we are seeking public comment on the different ways that the NSFR could affect market liquidity, including for different products, so we look forward to that feedback.

GOVERNOR POWELL. Great, thanks.

CHAIR YELLEN. Thank you. Governor Brainard?

GOVERNOR BRAINARD. So, you talked a little bit about how the NSFR would interact with our other liquidity requirements and supervisory practices. And I'm just wondering on the CLAR, which is a very powerful framework, which goes out to various time horizons beyond the 30 days of the LCR, how does this NSFR add to our ability to help ensure stability of funding at these institutions?

MICHAEL GIBSON. So I think the LCR and NSFR are complements in the regulatory space, and as I said in my opening remarks, in the supervisory area with CLAR, we're able to go in more detail and in different directions and maybe test for things that the regulations capture only in a broad way. But maybe in specific circumstances, we need to do a little bit more testing on the supervisory side. So, I think the NSFR just builds on to that, another leg--it's a similar sort of argument around complementarity of regulations that we've made in other contexts. I don't know if anyone else?

MARK VAN DER WEIDE. Yes, I think one of the ways that, one of the reasons that we like NSFR is that it does provide a fully standardized and fully comparable metric across firms, both domestically and globally, so we can do better comparisons across different firms using the same metric to assess their funding stability.

KEVIN LITTLER. I would add that--it adds this quantitative minimum flow, specifically links a firm's funding structure, the liquidity characteristics of these assets and commitments. So that's something that's baked into the structure.

GOVERNOR BRAINARD. I look forward to the public comments. Thank you, Madam Chair.

CHAIR YELLEN. There are no further questions. Before I ask for motions, I'd like to call on each of you to state your positions on the net stable funding ratio proposal. Vice Chair?

VICE CHAIRMAN FISCHER. In favor.

CHAIR YELLEN. Governor Tarullo?

GOVERNOR TARULLO. In favor. I look forward to the public comment.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. In favor. I look forward to the public comments.

CHAIR YELLEN. Governor Brainard?

GOVENOR BRAINARD. I'll go in favor. I look forward to the comments.

CHAIR YELLEN. I join my colleagues with the same view. Let me now call--we need two separate motions. First, I need a motion to approve publishing for comment the proposed rule to establish a minimum net stable funding ratio requirement for large banking organizations.

VICE CHAIRMAN FISCHER. Moved.

CHAIR YELLEN. Thank you.

GOVERNOR TARULLO. Second.

CHAIR YELLEN. Thank you. All in favor?

ALL GOVERNORS. Aye.

CHAIR YELLEN. Any opposed? No? Now I need motion to authorize staff to make technical changes and minor changes to prepare the related Federal Register documents for publication.

VICE CHAIRMAN FISCHER. So moved.

GOVERNOR TARULLO. Second.

CHAIR YELLEN. All in favor?

ALL GOVERNORS. Aye.

CHAIR YELLEN. I never assumed that no one would oppose. So thank you very much. Thanks for all the good work on this and we all look forward to the comments we'll receive. And I guess we can now move along to our second item. Governor Tarullo?

GOVERNOR TARULLO. Thank you, Madam Chair. The proposed regulation before us today represents another step forward in our efforts to make financial firms resolvable without either injecting public capital or endangering the overall stability of the financial system.

An important difference between large financial firms and most non-financial firms is that the former usually are party to large numbers of qualified financial contracts, or QFCs, which are by statute exempted from the automatic stay provisions of bankruptcy law that govern most other kinds of contracts and that allow firms entering bankruptcy to continue operations even as creditors' rights are determined in judicial proceedings. A financial firm entering bankruptcy is thus subject to an immediate and potentially destabilizing unwinding of derivatives, repo, and other instruments included within the definition of QFCs even if the firm

or its affiliates continue to perform on the contracts. The consequences can include loss of important funding sources and firesales of the collateral underlying these contracts.

The FDIC's bank resolution authority under the Federal Deposit Insurance Act and the orderly liquidation authority included in Title II of the Dodd-Frank Act provide for a one-business-day stay on the unwinding of QFCs, during which the resolution authority can choose which QFCs to have transferred to a solvent affiliate of the firm or a third party. However, there could be some question as to whether a foreign jurisdiction would recognize the exercise of this authority with respect to QFCs previously executed by a now insolvent U.S. financial firm or its subsidiaries in that jurisdiction.

To address both of these impediments to orderly resolution of large financial firms, the Federal Reserve joined a number of its international counterparts in working with the International Swaps and Derivatives Association (ISDA) to develop a protocol that allows the QFCs of the most systemically important firms to include provisions effectively extending the Title II QFC stay-and-transfer provisions to a range of resolution scenarios initiated under insolvency proceedings involving these firms. The eight U.S. firms that we have identified as carrying global systemic importance have already adhered to this protocol as part of their resolution planning process.

The regulation proposed by staff today would follow through on this work first by completing the regulatory process contemplated in the ISDA protocol and, second, by extending its requirements beyond transactions among systemically important banking organizations to transactions of these firms with all counterparties. In approving this proposal for comment and, eventually, adopting a final regulation, we have the opportunity to consolidate the substantial progress made in containing the risks to financial stability that can arise from QFCs.

Nonetheless, if Congress at some point addresses bankruptcy provisions applicable to financial firms, it could be useful to reconsider the breadth of collateral types that currently are eligible for QFC treatment.

And so now, Mike, again, I turn to you for the introduction to the staff presentation on this role.

MICHAEL GIBSON. Thank you, Governor Tarullo. This proposal pertains to financial transactions that are collectively known as QFCs. QFCs include derivatives contracts, repurchase agreements, also known as repos, and securities lending and borrowing agreements. Financial firms enter into QFCs for a variety of purposes, including to borrow money, to finance investments, to lend money, to manage risk, to enable clients and counterparties to hedge risks, to make markets in securities and derivatives, and to take positions in financial investments. QFCs play a role in economically valuable financial intermediation when markets are functioning normally. But they are also a major source of interconnectedness among financial firms, and this interconnectedness can pose a threat to financial stability in times of market stress.

As Governor Tarullo said, the failure of one financial entity can lead to the unwind of the QFCs of its affiliates, which could cause the affiliates to fail as well, and QFC unwinds can also lead to fire sales of large volumes of financial assets, pushing down the prices of similar assets held by other firms. This proposal focuses on a context in which the threat posed to financial stability by QFC unwinds is especially great, the failure of a global systemically important banking organization, or GSIB, that is party to large volumes of QFCs. The draft proposed rule is intended to mitigate this threat and facilitate the orderly resolution of a failed GSIB. I'll now turn

the presentation over to Felton Booker and Mark Savignac, who will describe the key features of the proposal.

FELTON BOOKER. Thank you, Mike. Today's proposal focuses on central prerequisite for the orderly resolution of any major financial firm, and that is the ability to place an entity within that firm into a resolution proceeding without immediately leading to the unwind of its vast quantities of QFCs. You know, as mentioned previously, through large volumes of QFCs, GSIBs are deeply interconnected with each other, with other major financial firms, and with the markets in which they all participate. The destabilization following the failure of the Lehman Brothers is a vivid illustration of the risk posed to--I'm sorry, posed by financial connectivity created through derivatives and other forms of QFCs. Early termination rights are an important element of the systemic risk presented by QFCs. Often, a non-defaulting party to a QFC, upon the failure of its counterparty or its counterparty's affiliate, can exercise early termination rights that it may have under that contract. Under the U.S. bankruptcy code for instance, a counterparty can exercise its contractual default rights immediately upon initiation of the bankruptcy proceeding against its direct counterparty. Statutory special resolution regimes like Title II of the Dodd-Frank Act or the special resolution powers of the Federal Deposit Insurance Act usually stay the right to termination of closeout for a brief period of time, as Governor Tarullo mentioned, to give the resolution authorities the opportunity to enforce those contracts if certain conditions are satisfied. These QFC stay provisions are important to the effectiveness of the U.S. special resolution regimes for financial firms. However, where it is not clear that those contracts are governed by U.S. law, there is a risk that a court in a foreign jurisdiction may decline to enforce the stays provided under Title II in the FDI Act. And that's the first obstacle.

Second and separately, the resolution strategies preferred by most U.S. GSIBs under the bankruptcy code involve some form of a single point of entry approach in which a U.S. parent entity would enter into an insolvency proceeding while its operating subsidiaries would remain solvent and continue to meet their obligations. However, the direct counterparties to QFCs with performing subsidiaries may nevertheless have determination rights that are exercisable upon the bankruptcy of its parent. A non-interrupted contractual right to terminate QFCs, retain and liquidate collateral under these circumstances can materially obstruct a plan resolution under the bankruptcy code by hastening the indiscriminate unwind of the firm's operating subsidiaries worldwide. That's the second obstacle.

Consequently, in 2014, the Board and the FDIC identified the exercise of certain default rights as an obstacle to the credibility of resolution plans required under the Dodd-Frank Act and directed the largest resolution plan filers, including U.S. GSIBs, to take action to correct this problem. It's important to note that this particular obstacle to an orderly resolution is one that's developed over time as a result of industry practice, rather than as a matter of a legal or statutory impediment. The bankruptcy code, for example, does not itself confer early termination rights upon QFC counterparties. It merely commits QFC counterparties to exercise such rights if they are provided under the contractual terms of the QFC. Therefore, a solution to this problem has and is largely in the control of the firms in their counterparties.

So, in response to the 2014 guidance provided by the Board and the FDIC, the resolution plan filers of this first wave group participated in an industry-wide effort to ensure that all financial contracts with counterparties to US GSIBs into the US operations of foreign GSIBs were subject to an appropriate stay on early termination. This effort which ultimately resulted in the launch of a resolution stay protocol was led by ISDA in coordination with the Board, the

FDIC, the OCC, and foreign regulators. The industry participants in this effort included ISDA members that represented asset management firms, pension firms, funds, and banking institutions, as well as other securities trades associations.

In fact, the ISDA resolution stay protocol provides a market-wide mechanism for GSIBs and their counterparties to adopt standardized amendments to OTC swap agreements, securities financing agreements and other forms of QFCs that address both the enforcement of resolution stays for contracts not governed by US law and the lack of an appropriate stay for contracts in certain resolution scenarios that are initiated under the bankruptcy code.

The US GSIBs and many of the foreign GSIBs as mentioned previously have already adhered to the ISDA protocol to modify the QFC transactions among that group of large dealer banks. And as a practical matter, one of the reasons today's proposal is needed is to implement ISDA's protocol provisions regarding the orderly resolution initiated under the bankruptcy code. Those provisions do not become effective until implemented by US regulation. But this proposal is also needed to help create greater consistency and transparency regarding the treatment of all financial counterparties during a GSIB resolution. That objective is a key consideration for extending the proposed restrictions beyond dealer banks and to all counterparties covered by the firm. This proposal, together with the ISDA protocol, will allow us to achieve the consistency and transparency that we've attempted through other resolution planning processes in a manner that imposes only modest cost on the system and requires those cost to be borne by GSIBs and their counterparties. I'll now turn to my colleague Mark Savignac to discuss further the details of the proposal.

MARK SAVIGNAC. Thank you, Felton. I will quickly walk through the main provisions of the draft proposed rule and explain how they address the two obstacles that Felton discussed.

This proposal is intended to improve the prospects for the orderly resolution of a GSIB and it would pursue that goal by prohibiting US GSIBs and the US operations of foreign GSIBs from entering into non-cleared QFCs that do not comply with the following restrictions. First, as Governor Tarullo discussed, the special resolution frameworks that Congress has created for failed financial firms under Title II of the Dodd-Frank Act and under the Federal Deposit Insurance Act, temporarily block a failed firm's QFC counterparties from exercising default rights and provide for the transfer of the failed firm's QFCs to a bridge company or another solvent firm. This proposal will build on this congressional action by requiring GSIBs to add contractual provisions to their QFCs to effectively opt into the treatment applied by those resolution laws, which should reduce the risk that a foreign court would disregard that treatment. And financial regulators and other jurisdictions are imposing similar requirements to ensure the cross-border application of their own resolution laws.

The second portion of the proposal should make it easier to resolve a GSIB in an orderly way by preventing the failure of one entity within a GSIB group from leading to the disorderly unwind of its affiliate's QFCs. To achieve this goal, the proposal would generally prohibit GSIB QFCs from allowing a counterparty to exercise default rights against a GSIB entity based on the entry into resolution of another entity within the GSIB group. This general prohibition would have exceptions for a number of creditor protections that would not be expected to interfere with an orderly resolution. And GSIBs could choose to comply with this portion of the proposal by signing up to the ISDA protocol and doing QFCs with counterparties that have themselves signed up.

Finally, the proposal would establish a procedure for the Board to review and approve QFCs with a different set of creditor protections, so long as those creditor protections are

consistent with the purposes of the proposal. This would give the Board the flexibility to approve slightly different contractual or arrangements without the need for a new rulemaking.

Under the proposal, the rule would take effect about a year after the Board issues a final rule. A GSIB would be required to conform preexisting QFCs to the rule only if it enters into a new QFC with the same counterparty or its affiliate after the rule's effective date. There are a couple of exceptions that I should describe. First, this proposal would not apply to subsidiary national banks of GSIBs or to federal branches of foreign GSIBs. The Office of the Comptroller of the Currency is expected to propose a similar set of restrictions to cover those entities' QFCs. Also, the current proposal would not apply to GSIB QFCs that are cleared through a central counterparty and we are continuing to consider how best to address impediments to GSIB resolution associated with cleared QFCs.

We believe that the proposal would yield substantial benefits for the economy of the United States by protecting US financial stability from the disorderly failure of a GSIB and that these benefits would greatly outweigh any associated costs. The most obvious cost for covered firms would be the cost associated with drafting and negotiating compliant contracts with their QFC counterparties and these costs would likely amount to only a very small fraction of the overall cost of conducting these firm's capital markets businesses. Covered firms may also need to offer better contractual terms to their QFC counterparties to compensate them for the loss of the default rights that would be restricted by the proposal.

We believe that the proposal would be unlikely to cause material reduction and QFC related economic activity. The proposed restrictions are relatively narrow and would generally not have a large effect on a counterparty's ability to prudently manage its risk and firms that are not GSIBs would not be subject to the proposed rule, so those firms could substitute for GSIBs to

some extent which could allow potential QFC counterparties with a strong demand for the prohibited default rights to transact with those firms and keep the default rights.

As for benefits, by increasing the likelihood that a failed GSIB could be resolved in an orderly way, the proposal would reduce the likelihood that GSIB failures will cause or deepen financial crises in the future. Financial crisis impose enormous costs on the economy, so even small reductions in the probability or severity of financial crises can do a lot of good. The proposal would also be likely to benefit the counterparties of a subsidiary of a failed GSIB by helping to prevent the disorderly failure of the subsidiary and allowing it to continue to meet its obligations. While it may be in the individual interest of any given counterparty to exercise available rights to run on a subsidiary, the mass exercise of those rights could harm the counterparties electively by causing an otherwise solvent subsidiary to fail. Thus, like the bankruptcy code's automatic stay, which also serves to maximize creditor's ultimate recoveries by preventing a disorderly liquidation of the debtor, the proposal would mitigate a collective action problem to the benefit of the failed firms, creditors, and counterparties. And because many creditors and counterparties of GSIBs are themselves systematically important financial firms including other GSIBs, improving outcomes for those creditors and counterparties would further protect the financial stability of the United States.

That concludes our prepared remarks and we would be happy to answer any questions you may have.

CHAIR YELLEN. Thank you very much. Let me just ask you one question. The restrictions that you're proposing here as you said only apply to GSIBs, and you mentioned in your presentation that counterparties who really want these protections now have the ability to transact with non-GSIBs but won't be covered. I wonder if you considered the possibility of

expanding the scope of the proposal so that it would cover large banking organizations arguably some of the same benefits that are approved to improving the resolvability of GSIBs might also apply to those not quite so systemic but nevertheless still large banking organizations. And are you concerned or do you think there will be a substantial amount of migration with activity within GSIBs toward institutions that aren't covered?

MARK VAN DER WEIDE. Madam Chair, staff grappled quite a bit with this question of the right scope of application for the QFC rule should be. In the end we decided the better proposal was one that limited the scope to the GSIBs significantly because those firms are the firms that we determined would pose the greatest threat to financial stability if they came under stress or were to fail. The proposal doesn't apply to other smaller bank holding companies in significant part because their derivatives books, their repo books, their aggregate QFC books are substantially smaller than those of the US GSIBs. So we felt like the protections were of less value for those firms. And given our statutory mandate to target our regulatory efforts towards those firms that pose the most threat of financial stability, we thought that was the right bargain to strike.

We don't expect the proposals can have a meaningful impact on the rights of counterparties so I think our expectations would be that the migration from GSIBs to non-GSIBs would be relatively small. We'll look forward to comments on that during the comment period. We expect a relatively small migration. To the extent there is migration, it's the movement of derivatives portfolios from our most systematically important firms to less systemically important firms. So there may be some financial stability benefit from that as the GSIB see smaller systemic footprints. But the trend that we'll need to monitor, we do have now a GSIB identification algorithm so that if we do see a very large volume of derivatives going to any

particular non-GSIBs, that will increase their systemic footprints quite rapidly under our formula so at some point they would become a GSIB themselves, become subject to our GSIB regulations including this QFC rule, so we do have that protective device but even with that protective device in place, we need to keep a watch I think on the migration that might occur.

We did grapple with this issue quite a bit. We do see competing considerations on both sides and so we included a question, the preamble that would explicitly see comment in whether we should broaden scope out to cover additional set of bank holding companies.

CHAIR YELLEN. Thank you very much. Vice chair?

VICE CHAIRMAN FISCHER. It's not clear from the--from the papers that we've seen whether a QFC is naturally defined and everybody knows *ex-ante* whether something is a QFC or not. In some places it seems to result from bargaining between the two sides as to whether it's a QFC. So how--how are they defined?

FELTON BOOKER. So, in the--What we've done is that we've used a defined term that is we believe well understood by the market and that is the QFC as defined under Title II of Dodd-Frank Act which effectively repeats QFC as defined under the FDI Act. So it is--We've not introduced any new confusion as to what the scope of QFC, so.

VICE CHAIRMAN FISCHER. But what's the answer to the--the question? These are well, well defined and everybody knows what they are. So I think the—

FELTON BOOKER. So I think the answer is largely yes. If there doesn't seem to be a meaningful confusion about what's in the bucket and what's not in the bucket, and to make sure that we weren't introducing again any confusion, we've used terms that the market seems to understand.

VICE CHAIRMAN FISCHER. Thank you.

CHAIR YELLEN. Governor Tarullo?

GOVERNOR TARULLO. Thank you, Madam Chair. I think it might be useful if one of you, one of the Marks maybe or Felton could explain the reasoning behind the transition provision that you've included in the proposal which would not in and of itself require that existing QFCs be modified to conform to the new requirements, but would require that existing QFCs with a particular counterparty be modified to come into conformity with requirement before any new QFC was entered into. And so I guess, if you could explain that a little bit more and maybe in the process of doing so address, you know, why not just require all existing contracts to be modified on the one hand or on the other hand, why not just wait for contracts naturally to run their course and to lapse and have a only new contract rule.

MARK VAN DER WEIDE. And I'll start and turn to you guys for follow-up. So this is another question that we spent quite a bit of time at the staff level grappling with. There are two competing considerations here from a public policy perspective. On the one hand, our GSIBs today, although they might have somewhat smaller QFC portfolios than they did and lead up to the crisis still have very large QFC portfolios, derivatives books in particular. And although some of them have been modified consistent with the ISDA protocol, the interdealer books, many of them remain, they continue to have the same really termination provisions that they've always had.

Given the high volumes of the QFC businesses of our GSIBs, given the long tenure of some of those agreements and particular on the derivative side, and that the early termination problems continues to be there, this is a pretty significant impediment to a GSIB orderly resolution for the foreseeable future. So, to the extent that we leave the existing portfolios in place, we are delaying by potentially a considerable period of time or confidence that we can do

an orderly resolution of the firm. So the more rapidly that we can fix this problem, the more rapidly we can have greater confidence about GSIB resolvability.

On the other hand, it is important I think to allow those counterparties that don't want to do business with GSIBs on the terms that our proposal would require to have some flexibility to opt out of the regime. And so, we've tried to strike the right balance in this proposal of these two competing considerations so that a counterparty that really doesn't want to do business with a GSIB without these contractual rights can leave their existing transactions in place untouched and go do business with a non-GSIB. Whether we struck the right balance or not is again something that we're going to hear from in the comment period and we look forward to those comments. But there are competing considerations here that need to be balanced.

GOVENOR TARULLO. So, Mark, part of that--part of your answer implicitly suggests that a lot of the existing QFCs are somewhat long duration.

MARK VAN DER WEIDE. Yes.

GOVENOR TARULLO. And thus would not actually lapse.

MARK VAN DER WEIDE. Yes, that's correct.

GOVERNOR TARULLO. Any set of--can you give a sense of a distribution there?

FELTON BOOKER. So I think that where you're going to see the largest duration is in the--in the swaps books, for example. If you would think about the US GSIBs and their interdealer transactions, which are covered by the current ISDA protocol, you would expect on a notional basis for that to be roughly in the area of 70 percent of those transactions. However--so that, of course, leaves again on the notional basis the 30 percent for non-dealers and other types of clients. On a mark-to-market basis, right, that number drops meaningfully to probably 40 percent, the transactions with the--among dealers are going to be shorter term even though larger

volumes of smaller number of longer term is going to get the mark-to-market coverage lower. And, of those--of that remaining group you have in a meaningful amount which has tenures of remaining maturities of greater than, you know, 10 years. So, I think that, you know, Mark is correct in thinking about the meaningful amount of the book that would be left untouched if we didn't cover existing.

CHAIR YELLEN. Thank you. Governor Powell? Governor Brainard? OK, let me, again, before we go to motions and call for round of position taking on the motion.

VICE CHAIRMAN FISCHER. In favor, Madam Chair.

GOVERNOR TARULLO. As am I.

GOVENOR POWELL. As am I.

GOVERNOR BRAINARD. And I think the crisis showed how damaging it is to have early termination provisions. I think the staff put a lot of time and effort into carefully crafting this, so I'm strongly in favor.

CHAIR YELLEN. Thank you and likewise. So, now, we ask for two motions again. First, I need a motion to approve publishing for comment the proposed rule to establish restrictions on qualified financial contracts of systemically important US banking organizations in the US operations with systemically important foreign banking organization. Do we have a motion?

VICE CHAIRMAN FISCHER. So moved.

CHAIR YELLEN. Thank you.

GOVERNOR TARULLO. Second.

CHAIR YELLEN. All in favor?

GOVERNOR TARULLO. Aye.

GOVERNOR POWELL. Aye.

GOVERNOR BRAINARD. Aye.

CHAIR YELLEN. And now, I need a motion to authorize staff to make technical changes and minor changes to prepare the related Federal Register document for publication.

VICE CHAIRMAN FISCHER. So moved.

CHAIR YELLEN. Thank you.

GOVERNOR TARULLO. Second.

CHAIR YELLEN. All in favor?

GOVERNOR TARULLO. Aye.

GOVERNOR POWELL. Aye.

GOVERNOR BRAINARD. Aye.

CHAIR YELLEN. Thank you. And thanks to the staff and Governor Tarullo and your committee for all the good work in preparing these to put out for comment and look forward to hearing the comments from the public. Thank you.