Transcript of Open Board Meeting

CHAIR YELLEN. Good morning and welcome to our guests who are attending or watching our meeting. The final rule we are considering today was proposed in May 2016 and continues the Board's work to ensure our financial system remains strong and stable and supports the economy through both good times and bad.

The final rule we are about to consider supports our strategy to reduce the potential systemic effect of the failure of a global systemically important bank--a GSIB. As I noted when this rule was proposed, the financial crisis showed that when a large financial institution gets into trouble, its failure can destabilize other firms and the broader financial system. One reason this might happen is that the very largest banks are interconnected through substantial volumes of financial contracts. Should these contracts, known collectively as Qualified Financial Contracts, or QFCs, unravel all at once at a failed GSIB, an orderly resolution of that firm can become far more difficult, sparking asset fire sales that can consume many firms.

That is why we are considering a final rule that will require GSIBs to use QFCs that limit termination rights that arise from the failure of a GSIB or its affiliates, so that there is time to transfer QFCs from a failed firm to a solvent one. This requirement will help manage the risk to the financial system when a GSIB fails, and will thus strengthen the resiliency of the financial system as a whole.

Let me now turn to Governor Powell who led the effort to complete this vital rule.

GOVERNOR POWELL. Thank you, Madam Chair.

The final rule that we are considering today addresses a key piece of the remaining business of post-crisis regulatory reform: improving the resolvability of the largest firms. The resolution planning process has required the largest U.S. banking firms to substantially improve their internal structures, governance, information systems, and allocation of capital and liquidity in ways that promote their resolvability. And the Board's total loss absorbing capacity, or TLAC, rule is helping ensure that the largest U.S. banking firms have enough "gone concern" loss absorbency to make resolution work.

This final rule on QFCs that we are considering today is an important element of our strategy to make large banking firms more resolvable. Without this final rule, the substantial numbers of QFCs that the largest firms have outstanding could be terminated when such a firm or one of its affiliates enters bankruptcy, risking a systemic disruption. 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--that is the two special resolution regimes that Congress has created for failed financial firms--both provide for a short stay on the termination of QFCs, during which the resolution authority can transfer some or all of the failed firm's QFCs to a solvent party. This final rule would help ensure that such temporary stays would apply to a broad range of the foreign and domestic QFCs of a failed GSIB, regardless of whether the resolution is conducted under the Federal Deposit Insurance Act, the Dodd-Frank Act, or the Bankruptcy Code. Accordingly, the final rule should help avoid the threat of a disorderly and mass unraveling of QFCs, as occurred in the case of Lehman Brothers, which intensified and prolonged the financial crisis.

The final rule is tailored to apply only to the global systemically important banks, the banking organizations whose disorderly failure or severe distress would likely pose the greatest risk to U.S. financial stability and the broader economy. We did review and carefully consider comments and looked for opportunities to reflect common sense changes to the proposed rule without sacrificing our goal to improve financial stability. In particular, because this final rule requires GSIBs to amend a large number of their contracts, we modified the timeline from the proposal to adopt a phased-in approach to give more time to conform contracts with less complex and less risky counterparties, such as community banks, pension funds, and insurance companies. The final rule also excludes QFCs that do not contain the types of provision that the final rule seeks to target, which will reduce the number of contracts that are affected. Staff will detail these and other amendments from the proposal. Accordingly, by focusing this rule exclusively on the relevant QFCs of GSIBs and making other changes to balance the costs of compliance with the benefits of the rule, we are promoting financial stability without creating unnecessary burdens.

And with that, I will turn to the Director of the Division of Supervision and Regulation, Mike Gibson. Mike?

MICHAEL GIBSON. Thank you, Governor Powell.

As Governor Powell stated, the draft final rule applies only to the largest and most significant financial firms: the eight U.S. GSIBs and the U.S. operations of foreign GSIBs. The purpose of the final rule is to help ensure that a failed GSIB’s passage through a resolution proceeding, such as bankruptcy or the special resolution process created by the Dodd-Frank Act, would be more orderly, thereby helping to mitigate destabilizing effects on the rest of the financial system.

The final rule pertains to several important classes of GSIB financial transactions that are known as QFCs. QFCs include derivatives contracts, repurchase agreements, or repos, and securities lending and borrowing agreements. GSIBs enter into QFCs for a variety of purposes, including to borrow money to finance investments, to lend money, and to manage risks.

QFCs play an economically valuable role 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. The failure of one financial entity can lead to the termination of the QFCs of its affiliates, which could cause the affiliates to fail as well, and QFC terminations can also lead to fire sales of financial assets, pushing down the prices of similar assets held by other firms. The final rule focuses on a context in which the threat posed to financial stability by QFC terminations is especially great, the failure of a GSIB that is party to large volumes of QFCs. The draft final rule is intended to mitigate this threat and facilitate the orderly resolution of a failed GSIB.

Before turning to the presenters, I want to thank the many staff members who worked on this important rule over a number of years. These accomplishments would not be possible without their considerable and sustained effort. I'll now turn the presentation over to Anna Harrington, Will Giles, and Sean Campbell who will describe the key features of the draft final rule.

ANNA HARRINGTON. Thank you, Mike.

In May 2016, the Board invited comment on a notice of proposed rulemaking to impose restrictions on the Qualified Financial Contracts, or QFCs, of U.S. GSIBs and the U.S. operations of foreign GSIBs. Approximately 30 comments were received on the proposal. The draft final rule is substantially similar to the proposed rule with certain key changes to address concerns raised by commenters. As Mike explained, the final rule under consideration today focuses on improving the orderly resolution of a GSIB. In particular, the requirements of the final rule seek to facilitate the orderly resolution of a failed GSIB by limiting the ability of the firm's QFC counterparties to terminate such contracts immediately upon entry of the GSIB or one of its affiliates into resolution.

As was mentioned previously, through large volumes of QFCs, GSIBs are deeply interconnected with each other and with other major financial firms and with global financial markets. For example, the triggering of default rights by counterparties of Lehman Brothers in 2008 was a key driver of its destabilization that resulted from the firm's failure. At the time of its failure, Lehman was party to large volumes of financial contracts, including over-the-counter derivatives. When its holding company declared bankruptcy, Lehman's counterparties exercised their default rights. The complexity and disruption associated with the termination of Lehman's portfolios of financial contracts led to a disorderly resolution.

The final rule in conjunction with other reforms is meant to help reduce the likelihood of potential systemic disruptions caused by a GSIB failure. The draft final rule under consideration by the Board today has two key elements that respond to the threat to financial stability posed by such default rights.

First, the final rule would require counterparties to QFCs with GSIBs to agree to contractual provisions that would opt into the temporary stay and transfer treatment of the Federal Deposit Insurance Act, or FDI Act, and the Dodd-Frank Act. The FDI Act and Title II of the Dodd-Frank Act create special resolution frameworks for failed financial firms that provide that the rights of a failed firm's counterparties to terminate their contracts are temporarily stayed when the firm enters a resolution proceeding. This short stay period is generally one business day, and allows time for the transfer of QFCs to a solvent counterparty.

Second, the final rule facilitates the resolution of a large financial entity under the U.S. Bankruptcy Code. The final rule achieves this goal by prohibiting a GSIB from being a party to a

QFC that would permit the exercise of a cross-default right. Cross-default rights are default rights related directly or indirectly to the entry into resolution of an affiliate. The prohibition on cross-default rights ensures that counterparties of solvent affiliates of the failed entity cannot terminate their contracts with a solvent affiliate based solely on the failed entity's resolution.

I'll now turn to my colleague, Will, to discuss the details of the final rule.

WILL GILES. Thank you, Anna.

The final rule is intended to facilitate implementation of the Universal Resolution Stay Protocol, developed by the International Swaps and Derivatives Association, in coordination with the Board, the FDIC, the OCC, and foreign regulators. The Universal Protocol is an efficient and standardized means to allow broad compliance with the final rule across firms that choose to adhere to its provisions. The Universal Protocol extends through contractual agreement the application of the special resolution regimes under U.S. law to all QFCs between a GSIB and other protocol adherents. The Universal Protocol also establishes restrictions on cross-default rights similar to those of the final rule. Because the protocol achieves outcomes similar to the final rule, the final rule permits firms to comply with the rule by adhering to the universal protocol.

The final rule also describes a new protocol that, if developed, could also be used to comply with the rule. This new protocol generally would be the same as the existing Universal Protocol, but for minor changes that are intended to address issues that are specific to buy-side financial counterparties, like asset managers, pension funds, and insurance companies. Therefore, GSIBs would be able to comply with the rule by using border-proof protocols or otherwise amending their QFCs.

The final rule, like the proposal, largely adopts the Dodd-Frank Act's definition of Qualified Financial Contract. Commenters argue that the proposed definition of QFC was too broad and would capture contracts that do not present any obstacles to an orderly resolution. In response, the final rule would include a number of modifications to the scope of the covered QFCs that serve to mitigate the burden of complying with the final rule without undermining its purpose. The final rule would exempt QFCs that do not include transfer restrictions or default rights, as these QFCs do not have the types of contractual provisions that the rule is intended to address. In addition, the final rule would provide that a GSIB is not required to conform investment advisory contracts with retail customers or existing warrants, because these contracts would be difficult to conform to the rules and requirements, and present limited risk to the resolution of a failed GSIB.

Under the proposal, the rule would have taken effect about a year after the Board issued the final rule. The draft final rule tailors the compliance burden by providing a longer and phased-in compliance schedule, as requested by commenters. The final rule would require a GSIB to conform covered QFCs with other GSIBs by January 1st, 2019. The final rule would provide an additional six months to conform QFCs with most other types of financial counterparties. Finally, GSIBs would have until the beginning of 2020, over two years in total, to conform QFCs with community banks and nonfinancial counterparties. Adopting a phased-in compliance approach based on the type of counterparty will allow market participants to assess and adjust to the new requirements. It would also give time for the development of the new protocol I described earlier or any other protocol that would meet the requirements of the final rule.

I will now turn to my colleague, Sean, to discuss the costs and benefits of the final rule.

SEAN CAMPBELL. Thanks, Will.

Staff believes that the final rule would yield substantial benefits for the economy of the United States by helping to reduce the harmful effects on U.S. financial stability from the disorderly failure of a GSIB, and that these benefits could substantially outweigh any costs associated with the draft final rule. In developing the final rule, the information regarding costs and benefits provided by commenters has been taken into account, as Governor Powell stressed, to address commenter's concerns.

The draft final rule contains a number of changes to reduce overall burden. In particular, the draft final rule would exclude contracts that commenters argued would be difficult or costly to remediate without an intended benefit to the resolution of a GSIB. Moreover, compliance through the use of a standardized protocol would reduce the legal and administrative costs of complying with the final rule. Finally, the gradual phase-in of the requirements would provide GSIBs, and their counterparties, with more time to manage the transition costs of complying with this rule.

Staff believes that the modifications made to the final rule address the most significant concerns raised by commenters regarding the burdens of the proposed rule, and should serve to mitigate the compliance costs of the final rule. Moreover, application of the final rule would be limited to GSIBs, which sensibly balances the costs and benefits of the rule by effectively managing systemic risk while limiting the burden of compliance by not requiring non-GSIB firms to comply with any part of this final rule.

In light of these and other changes that have been made to address commenter's concerns, the costs of the final rule are likely to be relatively small. These relatively small costs appear to be significantly outweighed by the substantial benefits that the rule would produce for the U.S.

economy. Financial crises impose enormous costs on the real economy, so even small reductions in the probability or severity of future financial crises creates substantial economic benefits. The final rule would materially reduce the risk of the financial stability of the United States that could arise from the failure of a GSIB by enhancing the prospects for the orderly resolution of such a firm, and would thereby reduce the probability and severity of financial crises in the future.

That concludes our prepared remarks. We would be pleased to answer any questions you might have.

CHAIR YELLEN. Thank you very much. Let me just start by adding my thanks to the staff with the very careful and thoughtful work you've done in bringing us this final rule.

I just have one question, and it pertains to the impact of this rule on the market more generally. As I understand it, this rule only applies directly to U.S. GSIBs and the U.S. operation of foreign GSIBs, but do you judge that the changes proposed here are likely to become market-wide, that this would be regarded as a best practice or that more generally throughout the market that these new practices would be adopted?

ANNA HARRINGTON. Thank you.

As you state, the final rule only applies directly to GSIBs. However, GSIBs must comply with respect to their covered QFCs with all their counterparties, and because GSIBs account for an overwhelming majority of QFCs, it's hard to predict, but you could see that this might become--as contracts are amended, it might become a standard industry practice.

CHAIR YELLEN. Thank you very much. Vice Chair?

VICE CHAIRMAN FISCHER. Just to follow up on that, I take it there's large-ish firm that isn't quite a GSIB that this could all migrate to?

ANNA HARRINGTON. Right now, most QFC activity is intermediated by--through GSIBs. That's why the rule applies to GSIBs and the U.S. operations of foreign GSIBs. So, staff believe the mass termination of QFCs presented the most significant challenges to the resolvability of GSIBs. I think this is something we'll always keep monitoring and non-GSIBs do engage in QFC activity, but perhaps not quite to the level where the resulting risks to financial stability are as significant as to GSIBs today.

SEAN CAMPBELL. And I think just one other point to make on that particular issue is that the extent to which banks engaged in OTC derivative activity is a factor that's considered in the determination as to whether or not they are a GSIB. So if you really had somebody that was on the bubble, and they tried to take up a lot of activity because they weren't subject to the rule, if they took up enough of that activity, they would cross the line into GSIB territory.

VICE CHAIRMAN FISCHER. O.K. I get--I get that one. And in terms of how to think about this for the--for those that are kind of puzzled by the whole thing, there is a sort of simple way of thinking about it, which is, when you have a bankruptcy, you try and stop the flow of money out of the bankrupt firm on that day and take time to get it down. But if you have some financial contracts that could be settled that day, then there's a big hole in, so to speak, the blockage of funds and all of that. And what this does is stop it. Stop the outflow.

SEAN CAMPBELL. Temporarily.

VICE CHAIRMAN FISCHER. Temporarily.

SEAN CAMPBELL. Temporarily.

VICE CHAIRMAN FISCHER. What is the length of time?

SEAN CAMPBELL. Generally one business day for the stays that would be required to be adhered to in the context of this rule. Generally, one business day.

VICE CHAIRMAN FISCHER. And that provides some time to get things done more systematically with less pressure of money flowing around the system.

SEAN CAMPBELL. Right. So I think that's exactly right, and again that, you know, generally one business day provides, you know, more time for the FDIC to provide for a more orderly resolution of the firm. And, you know, in particular, I think, basically, you know, what this rule is trying to address in the context of the adherence to those, you know, state protocols is akin to a very basic collective action problem which we face, which is for any single counterparty that faces a GSIB, when it starts to enter a resolution, it makes complete sense for that one counterparty to want to try and unwind that QFC and basically get its resources out of the financial entity as soon as possible. But we know, just like if a theater is on fire, it makes sense for one person to run for the exit. If they all run for the exit at the same time, we know what the end result is, and that's exactly the same collective action problem that we face here. And so by imposing those stays and basically providing for a temporary cool-off period, whereby the FDIC can come in and provide for a more orderly resolution that is in the end ultimately providing for more economic value for all of those participants to get in resolution at the end of the day.

VICE CHAIRMAN FISCHER. Just one last question, in terms of the data that are needed, this data is available in real-time?

SEAN CAMPBELL. Data on, for example? I'm not sure I follow.

VICE CHAIRMAN FISCHER. What are on the outstanding contracts? On the day the FDIC comes in...

SEAN CAMPBELL. Right.

VICE CHAIRMAN FISCHER. ...they’ve got a complete list of everything?

SEAN CAMPBELL. So, actually, interestingly enough, there's been a rule that has been passed in the not-too-distant past that actually requires large GSIBs to actually maintain up to the date--up-to-date records on their QFCs with all counterparties, and I think you're right, that operationally and logistically, you know, we mentioned and talked about the case of Lehman Brothers. I think it's well known that when Lehman Brothers went into resolution they had thousands upon thousands of QFCs with different counterparties, and just understanding the extent of those connections was itself a problem that was not surmountable in a 24- or 48-hour period, but the rule that's been passed by the--actually the U.S. Treasury in the last year or so actually requires GSIBs to maintain a current and up-to-the-date record of their QFCs with all counterparties just to be prepared for the kind of eventuality that this rule addresses.

VICE CHAIRMAN FISCHER. And we know that's technologically possible?

SEAN CAMPBELL. So the way that I think about is Excel now has a million rows. [Laughs.] So I think, technologically, we have the technology to track the QFCs with all counterparties.

VICE CHAIRMAN FISCHER. Thank you.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. Thank you, Madam Chair. These systemically important banks do a significant number of swaps and other QFCs with central counterparties, and, in many cases, they're doing those on behalf of another counterparty or a customer, and I wonder if you could just talk about how this rule applies to sort of both sides of that transaction?

ANNA HARRINGTON. Sure. So, the proposal excluded clear QFCs with a central counterparty, and the final rule does the same. The exclusion basically recognizes the unique benefits of central clearing and the role that plays in our financial system. One difference from the proposal, in response to comments that we received, the final rule actually broadens this exclusion to capture QFCs with financial market utilities, and, again, that's in recognition of the role, the special role of FMUs in our financial system.

GOVERNOR POWELL. And what about the other side of the trade? If there's a, you know, a customer on whose behalf they’re doing that?

ANNA HARRINGTON. So that was another highly commented upon aspect of the proposal. Commenters argued that the client-facing lag of a clear trade should likewise be excluded. The recommendation in the final rule is to include those types of QFCs in the final rule because we believe that termination of those QFCs could impact the resolvability of a GSIB.

CHAIR YELLEN. Governor Brainard?

GOVERNOR BRAINARD. Thank you, Madam Chair.

I've already had an opportunity to engage with the staff on this rule and the committee, led by Governor Powell, and I'm pleased that the final rule takes into account the key comments that we received I think in a thoughtful and appropriate way both in terms of tailoring the phased-in period, and also by somewhat narrowing the scope of the covered QFCs while I think still preserving the key safeguards for financial stability.

CHAIR YELLEN. Great. If there are no more questions, before we vote on the motions, I'd like to ask my colleagues to state their positions on the rule. Vice Chair?

VICE CHAIRMAN. I support it.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. I would just echo Governor Brainard's comments. This has been a long and careful process, and I think, as usual, we've given very careful thought to the comments. We've had long discussions in our committee, and I'm pleased with the result, and I commend the staff for excellent work on this project, and I support it.

GOVERNOR BRAINARD. Yeah, and I, too, I support it. I think this is really in some respects a key remaining pillar, as I think about it, that will both learning the lessons from Lehman's failure during the crisis allow us to feel confident that the largest and most complex institutions can fail in an orderly way, and it really sits alongside our long-term debt rule, our clean holding company rule, and the other requirements that we've put in place, and so, I'm very pleased to support this.

CHAIR YELLEN. And let me join my colleagues in expressing my own support for the final rule, and thanking the staff for the careful way in which you've addressed the comments and agree with characterization that this is an important piece in enhancing the odds of a successful resolution.

So, with that, let me--we will need to vote on three separate motions. First, I need a motion to approve final rule, establishing restrictions on qualified financial contracts of systemically important U.S. banking organizations and the U.S. operations of systemically important foreign banking organizations, and making technical conforming amendments to the definition of qualifying, master netting agreement, and related definitions in the Board's capital and liquidity rules.

VICE CHAIRMAN FISCHER. So moved.

CHAIR YELLEN. All in favor?

ALL. Aye.

CHAIR YELLEN. Second, I need a motion to authorize staff to make conforming, non-substantive changes, such as those requested by the OCC and FDIC, as part of their approval process of substantially similar final rules.

VICE CHAIRMAN FISCHER. So moved.

CHAIR YELLEN. All in favor?

ALL. Aye.

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

VICE CHAIRMAN FISCHER. So moved.

CHAIR YELLEN. All in favor?

ALL. Aye.

CHAIR YELLEN. Well, you have unanimous approval of all the-- the entire set of recommendations, and, again, we thank you very much for your hard work on this, and think this is a very important element of our response to the crisis. Thank you.

VICE CHAIRMAN FISCHER. Thank you.