BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date:	April 27, 2016
To:	Board of Governors
From:	Governor Tarullo DKT
Subject:	Proposed 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

---

Attached are a memorandum to the Board and a draft *Federal Register* notice of proposed rulemaking that would establish restrictions on the qualified financial contracts (QFCs)—such as derivatives contracts and repurchase agreements—of U.S. global systemically important banking organizations (GSIBs) and the U.S. operations of foreign GSIBs. The proposal would require the QFCs of GSIBs to contain contractual provisions that recognize the automatic stay of termination provisions and transfer provisions applied in resolutions under the Dodd-Frank Act and the Federal Deposit Insurance Act. The proposal would also generally requires QFCs of GSIBs to prohibit a counterparty to the QFC to exercise default rights based on the entry into resolution of an affiliate of the GSIB.

The proposal is intended to address the threat to orderly resolution (and, in turn, to financial stability) posed by the disorderly unwind of a failed GSIB's QFCs. The proposal would complement the Board's recently proposed rule on total loss-absorbing capacity (TLAC), long-term debt, and clean holding company requirements for U.S. GSIBs and the U.S. intermediate holding companies of foreign GSIBs, and is intended to protect the financial stability of the United States by further facilitating the orderly resolution of a failed GSIB.

Staff seeks the Board's approval of the attached draft notice of proposed rulemaking, and requests authority to make minor changes to the document prior to its publication in the *Federal Register*.

The Committee on Bank Supervision has reviewed the proposal, and I believe that it is ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: April 27, 2016

To: Board of Governors

From: Staff[1]

Subject: Proposed 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

ACTIONS REQUESTED: Staff seeks approval to invite public comment on the attached draft proposed rule ("proposal") and accompanying *Federal Register* notice. The proposal would impose restrictions on the qualified financial contracts (QFCs)—such as derivatives contracts and repurchase agreements—of U.S. global systemically important banking organizations (GSIBs)[2] and the U.S. operations of foreign GSIBs (covered entities). The proposal would also make technical, conforming amendments to definitions in the Board's capital and liquidity rules. Additionally, staff seeks approval to make minor changes to the draft *Federal Register* documents in order to prepare them for publication.

EXECUTIVE SUMMARY:

- **Objective**: The proposal aims 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 the entry of the GSIB or one of its affiliates into resolution. It would achieve this by requiring the inclusion of contractual restrictions on the exercise of certain default rights in those QFCs. Given the large volume of QFCs to which covered entities are a party, the exercise of default rights en masse as a result of the failure of a covered entity could lead to a disorderly resolution if the failed firm were forced to sell off assets, which could spread contagion by increasing volatility and lowering the value of similar assets held by other firms, or to withdraw liquidity that it had provided to other firms.
- **Key provisions**: The proposal would address these concerns by:
    - o Requiring the QFCs of covered entities to contain contractual provisions that opt into the temporary stay-and-transfer treatment of the Federal Deposit Insurance Act (FDI Act) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), thereby reducing the risk that the stay-and transfer treatment would be challenged by a QFC counterparty or a court in a foreign jurisdiction. The FDI Act

[1] Messrs. and Mmes. Gibson, Van Der Weide, Booker, and Savignac (Division of Banking Supervision and Regulation), and Alvarez, Giles, and Chang (Legal Division).

[2] The eight firms currently identified as U.S. GSIBs are Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., Goldman Sachs Group, Inc., JP Morgan Chase & Co., Morgan Stanley Inc., State Street Corporation, and Wells Fargo & Company.

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 to allow for the transfer of the relevant obligations under the QFC to a party with resources to perform the obligations; and

  - Prohibiting the counterparties of QFCs of covered entities from exercising default rights based on the entry into resolution of an affiliate of the covered entity (cross-default rights), subject to certain creditor protection exceptions that would not be expected to interfere with an orderly resolution.

- **ISDA Protocol**: The proposal facilitates the implementation of the International Swaps and Derivatives Association 2015 Resolution Stay Protocol (ISDA Protocol), which extends, through contractual agreement, the application of the resolution frameworks in the FDI Act and the Dodd-Frank Act to all QFCs entered into by a bank holding company and its subsidiaries, including QFCs entered into by covered entities outside the United States, and establishes restrictions on cross-default rights that are similar to those of the proposal. The proposal is necessary to implement the ISDA Protocol's provisions regarding the resolution of a GSIB under the U.S. Bankruptcy Code, as these provisions do not become effective until implemented by U.S. regulations. To support further adherence to the ISDA Protocol, the proposal would create a safe harbor for QFCs that have been amended pursuant to the ISDA Protocol by allowing covered entities to sign up to the ISDA Protocol as an alternative to contractually implementing the proposal's restrictions.

- **Transition period**: The proposal would take effect on the first day of the first calendar quarter that begins at least one year after the issuance of the final rule. A covered entity would be required to conform pre-existing QFCs only if the covered entity or an affiliate enters into a new QFC with the same counterparty or an affiliate of the counterparty after the rule goes into effect.

- **Impact assessment**: Staff believes the cost of the proposal would be modest, would be borne by GSIBs and their counterparties, and would be outweighed by the proposal's benefits for the financial stability of the United States.

DISCUSSION: QFCs, which include derivatives, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, are a valuable tool of financial intermediation that financial firms enter into 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. These transactions are also a major source of interconnectedness among large firms such as GSIBs and, as such, can pose risks to financial stability in times of market stress and in the event of the failure of such a firm. The proposal focuses on those risks presented by the failure of a covered entity that is a party to a large number of QFCs, including QFCs with counterparties that are themselves systemically important.

A party to a QFC generally has the right to take certain actions if its counterparty defaults—that is, if the counterparty fails to meet certain contractual obligations. Common default rights include the right to suspend performance of the non-defaulting party's obligations, the right to terminate or accelerate the contract, the right to set off amounts owed between the parties, and the right to seize and liquidate the defaulting party's collateral. The QFC may provide that these and other default rights can be exercised in a variety of circumstances, including when the direct party to the QFC or any of its affiliates enters resolution, regardless of whether the direct party is still meeting its obligations under the QFC.

The exercise of these default rights can undermine financial stability in several ways. If QFC counterparties exercise default rights en masse, they may drain liquidity from the failed covered entity, forcing the firm to sell off assets. If the assets in question are not highly liquid, then a firm may have to sell at firesale prices, which (depending on the size of the selloff) could spread contagion by increasing volatility and lowering the value of similar assets held by other firms. The covered entity may also respond to a QFC run by withdrawing liquidity that it had offered to other firms, forcing them to engage in firesales. Similar effects could result if the defaulting covered entity's QFC counterparty itself liquidates the QFC collateral at firesale prices. Where these effects occur en masse, such as upon the failure of a covered entity that is party to a large volume of QFCs, they may pose a substantial risk to financial stability.

For these reasons, the special resolution frameworks that Congress has created for failed financial firms under the FDI Act and Title II of the Dodd-Frank Act impose stays on QFC default rights and provide for the transfer of a failed firm's QFCs to a solvent financial company. The proposal would require that these stay-and-transfer provisions applicable to the resolution of a systemically important financial company apply to all QFCs of covered entities, including those entered into by the GSIB outside the United States.

The proposal also is intended to facilitate implementation of the ISDA Protocol. The Protocol was developed by market participants that are members of the International Swaps and Derivatives Association, Inc. (ISDA), in coordination with the Board, the FDIC, the OCC, and foreign regulators. The ISDA Protocol extends, through contractual agreement, the application of the resolution frameworks of the FDI Act and Title II of the Dodd-Frank Act to all QFCs entered into by a bank holding company and its subsidiaries and establishes restrictions on cross-default rights similar to those of the proposal. The proposal is necessary to implement the ISDA

Protocol primarily because the ISDA Protocol's provisions regarding cross-default restrictions in the bankruptcy context do not become effective until implemented by U.S.regulations. The proposed rule would also ensure that all GSIBs and their counterparties adhere to the ISDA Protocol or take contractual steps that have the same effect.

A. Restrictions on the QFCs of Covered Entities

1. Scope

The proposal would apply to U.S. GSIBs, the subsidiaries of U.S. GSIBs, and the U.S. operations (including U.S. subsidiaries, U.S. branches, and U.S. agencies) of foreign GSIBs. However, the proposal would exempt "covered banks," which would be defined to include OCC-supervised entities (such as national banks). The OCC is expected to propose substantively identical restrictions on the QFCs of covered banks in the near future.

The proposal would adopt the Dodd-Frank Act's definition of "qualified financial contract." Under that definition, QFCs include derivatives contracts, repo transactions, securities lending and borrowing transactions, and credit support enhancements that apply to other QFCs, along with a few other types of financial transactions.

The proposal's requirements would not apply to QFCs to which a central counterparty (CCP) is a party. Staff continues to consider the appropriate treatment of centrally cleared QFCs in light of differences between cleared and uncleared QFCs with respect to contractual arrangements, counterparty credit risk, default management, and supervision. **(*See Attachment pp. 24–32.*)**

2. Required contractual provisions related to the U.S. special resolution regimes

Under the proposal, a QFC to which a covered entity is party (covered QFC) would be required to explicitly provide (1) that the transfer of the covered QFC would be effective to the same extent as under the U.S. special resolution regimes and (2) that default rights with respect to the covered QFC can be exercised to no greater extent than they could be under the U.S. special resolution regimes. This provision would apply the transfer provisions and limits on default rights contained in Title II of the Dodd-Frank Act and FDI Act to all QFCs to which a covered entity is party, including those entered into outside the United States with foreign counterparties. This portion of the proposal would reduce the risk that a counterparty in a foreign jurisdiction would challenge and disregard the stay and transfer provisions. Financial regulators in other jurisdictions have taken similar actions to ensure the cross-border application of their own special resolution regimes. **(*See Attachment pp. 34–37.*)**

3. Prohibited cross-default rights

The proposal would prohibit a covered entity from being party to a QFC that would permit the exercise of a default right that is related to the entry into resolution of an affiliate of the covered entity. The proposal would also generally prohibit a covered entity from being party to a QFC that would prohibit the transfer of a credit enhancement applicable to the QFC (such as a guarantee) from an affiliate covered entity to a transferee. These limits on default rights would apply to default provisions triggered by either entry into Title II resolution or entry into bankruptcy.

Notwithstanding the general prohibition, under the proposal, a QFC could permit a covered entity's counterparty to exercise default rights based on the covered entity's own entry into resolution, the covered entity's failure to make a required payment or delivery, or the failure of an affiliate covered entity or a transferee to make a payment or delivery required under a credit enhancement that supports the QFC.

Moreover, upon the expiration of a short "stay period" required by the proposal (generally one business day[3]), a covered QFC could allow the exercise of default rights if the affiliate enters liquidation proceedings, if one or more of the counterparty's QFCs are not transferred or assumed, or if the affiliate's assets are not also transferred to the transferee (if any). These conditions identify situations in which the covered entity's QFC counterparty is no longer receiving the full benefit of the credit enhancement.

The purpose of the proposal's prohibition on cross-default rights is to facilitate the orderly resolution of a GSIB under an SPOE strategy, or another strategy under which some of the failed entity's affiliates continue to meet their obligations and do not enter resolution, by preventing the failure of one entity within a group from leading to the disorderly unwind of its affiliates' QFCs and allowing the transfer of credit enhancements to a solvent entity. This portion of the proposal is modeled on section 210(c)(16) of the Dodd-Frank Act, which addresses the threat that QFC cross-default rights pose to orderly resolution by empowering the FDIC as receiver to prevent the QFC counterparties of the failed firm's subsidiaries from exercising default rights based on the insolvency, financial condition, or receivership of the

[3] The proposed stay period would expire at the later of 5:00 p.m. on the next business day or 48 hours after the entity's entry into resolution.

failed firm, and to transfer credit enhancements to a bridge financial company or third party before the end of a stay period. **(*See Attachment pp. 37–48.*)**

4. Compliance with the ISDA Protocol

A covered entity may comply with the requirements governing cross-default rights either by amending the contractual provisions of its QFCs directly or by adhering to the ISDA Protocol. By signing up to the ISDA Protocol and its annexes, market participants can amend their QFCs to restrict the exercise of cross-defaults in a manner similar to that required by the proposal's prohibition on cross-default rights.

This safe harbor treatment is intended to encourage market participants to sign up to the ISDA Protocol. While the ISDA Protocol includes broader creditor protections than would otherwise be permitted under the proposal and therefore allows for a somewhat greater risk of destabilizing QFC unwinds,[4] it also has attractive features that the proposal lacks. When a market participant signs up to the ISDA Protocol, it must do so with respect to all covered entities that have signed up and also with respect to all covered transactions, both future and existing. As noted below, the proposed rule would apply to existing transactions between a counterparty and a GSIB only if the two parties enter into new QFCs after the rule is effective; that is, the proposed rule applies only when a GSIB enters new transactions. Thus, a market participant that chooses to sign up to the ISDA Protocol would not be able to pick and choose which transactions with which counterparties will be amended. That outcome would protect financial stability by promoting consistent treatment throughout the financial system. **(*See Attachment pp. 48–54.*)**

5. Procedure for Board approval of enhanced creditor protections

The proposal would permit a covered entity to request that the Board approve as compliant with the proposal's cross-default prohibition a set of creditor protections that are broader than, or different from, the ones that are permitted by the rule. The Board could approve such a request if the requested terms would mitigate risks to U.S. financial stability from a GSIB failure to at least the same extent as compliance with the proposal's prohibition on cross-default

---

[4] For example, the Protocol would allow a counterparty with a guarantee to exercise default rights if, where the guarantee is not transferred, the bankruptcy court does not grant the counterparty's guarantee administrative expense status by the end of the stay period or if, where the guarantee is transferred, the transferee does not satisfy a material payment or delivery obligation to any of its creditors. Like the creditor protections otherwise permitted by the proposal, these additional creditor protections are unlikely to be triggered in an orderly resolution.

rights would. The proposal lays out a set of factors that the Board would consider in reviewing such a request.

The proposed approval process would give the Board the flexibility to approve slightly different contractual arrangements without the need for a new rulemaking. **(*See Attachment pp. 55–57.*)**

6. Transition period

Under the proposal, the rule would take effect on the first day of the first calendar quarter that begins at least one year after the issuance of the final rule. After the effective date, a covered entity would be required to ensure that all new covered QFCs comply with the rule. A covered entity would not be required to bring preexisting QFCs into compliance if neither that covered entity nor any affiliate that is also a covered entity enters into a new QFC with the same party or its affiliates on or after the effective date. However, a covered entity would be required to bring preexisting covered QFCs into compliance no later than the first date on or after the effective date on which the covered entity or an affiliate that is also a covered entity enters into a new QFC with the same counterparty or an affiliate of the same counterparty.

An entity that becomes a covered entity after the final rule is issued would be required to comply by the first day of the first calendar quarter that begins at least one year after the entity becomes a covered entity.

A transition period is appropriate because covered entities will likely need time to renegotiate noncompliant contracts, including contracts with counterparties that are not currently adherents to the ISDA Protocol. By permitting a covered entity to remain party to noncompliant QFCs entered into before the effective date unless the covered entity enters into new QFCs with the same counterparty or its affiliates, the proposal strikes a balance between ensuring QFC continuity if the GSIB were to fail and ensuring that covered entities and their existing counterparties can avoid any compliance costs and disruptions associated with conforming existing QFCs by refraining from entering into new QFCs. **(*See Attachment pp. 57–59.*)**

7. Costs and benefits

Staff believes that the proposal would yield substantial benefits for the economy of the United States by helping reduce the harmful effects on U.S. financial stability from the disorderly failure of a GSIB and that these benefits would substantially outweigh any costs associated with the proposal. The costs of the proposal to covered entities would include the relatively small costs associated with drafting and negotiating compliant contracts with potential QFC counterparties. These costs would be small relative to the revenue of covered entities and to the costs of doing business in the financial sector generally. Covered entities may also need to offer better contractual terms to their QFC counterparties in order to compensate them for the loss of their ability to exercise the default rights that would be restricted by the proposal. These costs may be higher than the drafting and negotiating costs. However, they are also expected to be relatively small because of the limited nature of the rights that counterparties would be required to give up, the low likelihood that the counterparty will have to exercise these rights, and the availability of other forms of protection for counterparties.

The proposal could also create economic costs by causing a marginal reduction in QFC-related economic activity. However, any such decline is unlikely to be material. The proposed restrictions on default rights in covered QFCs are relatively narrow and would not affect a counterparty's rights in the event a GSIB fails to make payment on a QFC, or in response to its direct counterparty's entry into a bankruptcy proceeding (that is, the default rights covered by the Bankruptcy Code's "safe harbor" provisions). Counterparties are also able to prudently manage risk through other means, including entering into QFCs with entities that are not GSIB entities and therefore would not be subject to the proposed rule..

Additionally, the stay-and-transfer provisions of the Dodd-Frank Act and the FDI Act are already in force, and the ISDA Protocol is already partially effective. To staff's knowledge, no material economic costs have arisen as a result. This observation provides further support for the view that any marginal costs created by the proposal—which is intended to extend the effects of the stay-and-transfer provisions and the ISDA Protocol—are unlikely to be material.

Thus, the costs of the proposal 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 create substantial economic benefits. The proposal would materially reduce the risk to 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 materially reduce the probability and severity of financial crises in the future.

Moreover, the proposal would likely benefit the counterparties of a subsidiary of a failed GSIB by preventing the disorderly failure of the subsidiary and allowing it to continue to meet its obligations. Preventing the mass exercise of QFC default rights at the time the parent or other affiliate enters resolution proceedings makes it more likely that the subsidiaries or other affiliates will be able to meet their obligations to QFC counterparties. Moreover, the creditor protections permitted under the proposal would allow any counterparty that does not continue to receive payment under the QFC to exercise its default rights. **(*See Attachment pp. 59–61.*)**

B. Technical Amendments to Certain Definitions

The proposal would also make technical amendments to the definitions of the following terms in the Board's capital and liquidity rules: qualified master netting agreement, collateral agreement, eligible margin loan, and repo-style transaction. The amendments will prevent the proposal from having unintended disruptive effects on the treatment of regulated firms' netting sets under the Board's capital and liquidity rules. The Board has previously made similar amendments to these definitions to ensure that foreign special resolution regimes and firms' adherence to the 2014 version of the ISDA Protocol would not cause unintended disruptions to the rules' treatment of netting sets.[5] **(*See Attachment pp. 61–64.*)**

CONCLUSION: Staff recommends that the Board approve the attached draft proposed rule to impose restrictions on the QFCs of covered entities and make technical amendments to certain definitions in the Board's capital and liquidity rules. The *Federal Register* notice would invite the public to comment on the proposal until August 5, 2016. Staff also seeks approval to make minor changes to the draft *Federal Register* documents to prepare them for publication.

Attachment

[5] 79 FR 78287 (Dec. 30, 2014).