

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: August 24, 2017
To: Board of Governors
From: Governor Powell 
Subject: 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

Attached are a memorandum to the Board and a draft *Federal Register* notice and draft final rule 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 final rule 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 Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act. The final rule would also generally require QFCs of GSIBs to prohibit a counterparty to the QFC from exercising cross-default rights (i.e., default rights based on the entry into resolution of an affiliate of the GSIB).

The final rule would address the threat to orderly resolution (and, in turn, to financial stability) posed by the disorderly unwind of a failed GSIB's QFCs. The final rule would complement the Board's final 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 and draft final rule, and requests authority to make minor and conforming changes to the document prior to its publication in the *Federal Register*.

The Committee on Supervision and Regulation was briefed on the final rule on July 18, 2017, and I believe that these materials are ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: August 24, 2017
To: Board of Governors
From: Staff¹
Subject: 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

ACTIONS REQUESTED: Approval of the attached draft Federal Register notice and draft final rule that 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”).³ The final rule would also make technical, conforming amendments to definitions in the Board’s capital and liquidity rules. Staff also requests the authority to make conforming, nonsubstantive changes (e.g., to make changes requested by the OCC and FDIC as part of their approval process of substantially similar final rules), and technical and minor changes (e.g., wording and formatting) to the attached materials to prepare them for publication in the Federal Register.

EXECUTIVE SUMMARY:

- **Objective:** The final rule would 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. In particular, the final rule would achieve this goal by requiring the inclusion of contractual restrictions on the exercise of certain default rights in the QFCs of covered entities. 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.

¹ Messrs. Gibson and Campbell and Ms. Harrington (Division of Supervision and Regulation); Mr. Van Der Weide, Ms. Schaffer, Mr. Giles, and Ms. 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.

³ There are currently 20 foreign GSIBs with U.S. operations.

- **Key provisions:** The final rule would address these concerns by:
 - 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 Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) (together, the “U.S. Special Resolution Regimes”), 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 U.S. Special Resolution Regimes 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 cross-default rights (i.e., default rights based on the entry into resolution of an affiliate of the covered entity), subject to certain creditor protection exceptions that would not be expected to interfere with an orderly resolution.
- **Industry Protocols:** The final rule facilitates the implementation of the International Swaps and Derivatives Association 2015 Resolution Stay Protocol (“Universal Protocol”). The Universal Protocol extends, through contractual agreement, the application of the resolution frameworks in the U.S. Special Resolution Regimes 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 final rule would create a safe harbor for QFCs that have been amended pursuant to the Universal Protocol by allowing covered entities to sign up to the Universal Protocol as an alternative to contractually implementing the restrictions of the final rule. The final rule also permits compliance with the final rule through adherence to a new protocol (“U.S. Protocol”) that is the same as the existing Universal Protocol but for minor changes intended to address issues that are specific to the buy-side counterparties that are expected to adhere to the new protocol.
- **Transition period:** The final rule would require compliance between one to two years from the effective date depending on the type of counterparty to the QFC. Covered entities would have one year to conform QFCs with other covered entities, 18 months to conform QFCs with most other financial counterparties, and two years to conform QFCs with community banks and all other counterparties. 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 a consolidated affiliate of the counterparty after the relevant compliance date.
- **Impact assessment:** Staff believes the cost of the final rule would be modest, would be borne by GSIBs and their counterparties, and would be outweighed by the rule’s benefits for the financial stability of the United States.

BACKGROUND: 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 final rule focuses on the 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 of a covered entity 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 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 U.S. Special Resolution Regimes impose stays on QFC default rights and provide for the transfer of a failed firm's QFCs to a solvent financial company. The final rule requires that these stay-and-transfer provisions apply to all QFCs of covered entities, including those entered into by the GSIB outside the United States.

The final rule also is intended to facilitate implementation of the Universal Protocol. The Universal 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 Universal Protocol extends, through contractual agreement, the application of the resolution frameworks of the U.S. Special Resolution Regimes 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 final rule. The final rule is necessary to implement the Universal Protocol primarily because the Universal Protocol's provisions regarding cross-default restrictions in the bankruptcy context do not become effective until implemented by U.S. regulations. In addition, the final rule, if issued before 2018, would prevent existing adherents from opting out of the Universal Protocol's provisions regarding the U.S. Special Resolution Regimes. The final rule also permits compliance with its requirements through adherence to a new protocol, the U.S. Protocol, which would be the same as the existing Universal Protocol but for minor changes that are intended to address issues that are specific to the buy-side counterparties that are expected to adhere to the new protocol. Accordingly, the final rule would also ensure that all GSIBs and their counterparties adhere to the Universal Protocol or U.S. Protocol, or otherwise amend their QFCs to conform to the rule.

The Board received approximately 30 comments on the proposal from banking organizations, trade associations, public interest groups, and private individuals. The comments addressed a wide variety of aspects of the proposal as described further below, including the potential costs and burdens of various aspects of the proposal. Staff also met with some commenters at their request to discuss their concerns with the proposal. Staff has reviewed the comments received in response to the proposal and modified the proposal to address commenter concerns in a manner consistent with the intended purpose of the final rule as described in more detail below. In addition, Board staff consulted with certain U.S. federal financial agencies, including the OCC and FDIC, and foreign regulators. This final rule is also consistent with analogous legal requirements that have been imposed in other national jurisdictions and with the Financial Stability Board’s “Principles for Cross-border Effectiveness of Resolution Actions.”⁴

The OCC and FDIC intend to finalize substantively identical final rules to that of the Board in the near future. The OCC’s rule would cover national banks, U.S. federal branches, and U.S. federal agencies that are supervised by the OCC, and the FDIC’s rule would cover state savings associations and state non-member banks that are supervised by the FDIC. Staffs of the agencies have endeavored to harmonize their respective rules to the extent possible and to provide specificity and clarity in the final rules to minimize the possibility of conflicting interpretations or uncertainty in their application. Moreover, staffs of the agencies intend to consult with each other and coordinate as needed regarding implementation of the final rule.

⁴ Financial Stability Board, “Principles for Cross-border Effectiveness of Resolution Actions” (November 3, 2015), available at <http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf>.

SUMMARY OF THE DRAFT FINAL RULE

A. Restrictions on the QFCs of Covered Entities

1. *Scope of Covered Entities*

The final rule 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. Because the FDIC and OCC intend to finalize substantively identical final rules to that of the Board, the definition of “covered entity” in the draft final rule excludes GSIB entities that are state savings associations and state non-member banks, which the FDIC’s final rule should address, and national banks, federal savings associations, U.S. federal branches, and U.S. federal agencies, which the OCC’s rule should address (together, “excluded banks”).

The draft final rule continues to define “subsidiary” by reference to the Bank Holding Company Act (“BHC Act”), which is consistent with the U.S. Special Resolution Regimes.⁵ A number of commenters urged the Board to move to a financial consolidation standard to define a “subsidiary” of a covered entity instead of the definition under the BHC Act.⁶ Commenters argued that financially consolidated subsidiaries are generally subject to operational control and generally fully integrated into the parent’s enterprise-wide governance and control frameworks,

⁵ The BHC Act defines control of a company (e.g., a subsidiary or affiliate) as the ownership, control, or power to vote of 25 percent or more of any class of voting security of the company; control in any manner of the election of a majority of directors of the company; or the exercise of a controlling influence over the management or policies of the company. 12 U.S.C. § 1841(a)(2). Under Generally Accepted Accounting Principles, for example, a company generally would consolidate an entity in which it holds a majority voting interest or over which it has the power to direct the most significant economic activities, to the extent it also holds a variable interest in the entity.

⁶ Commenters expressed a similar view with respect to the definition of “affiliate” which was likewise defined by reference to BHC Act control under the proposal. Certain commenters also noted that the Universal Protocol defines “affiliate” in a manner similar to principles of financial consolidation by reference to ownership of a majority of the voting power of an entity or person.

information technology systems, and management systems. Moreover, commenters contended that entities that are not consolidated with a GSIB for financial reporting purposes are unlikely to impede the orderly resolution of the GSIB.

U.S. GSIBs generally enter into QFCs through subsidiary legal entities rather than through the top-tier holding company. Maintaining consistent definitions of a covered entity's subsidiaries with the U.S. Special Resolution Regimes should better ensure that QFC stays are effected in resolution under a U.S. special resolution regime.⁷

2. Scope of Covered QFCs

The final rule, like the proposal, would adopt the Dodd-Frank Act's definition of "qualified financial contract." Commenters argued that the proposed definition of QFC was too broad and would capture contracts that do not present any obstacles to an orderly resolution. Commenters urged the Board to exclude a variety of types of QFCs from the requirements of the final rule, including: (1) QFCs that do not contain any transfer restrictions, direct default rights, or cross-default rights (e.g., cash securities transactions and foreign exchange spot transactions), because these types of QFCs do not give rise to the risk that counterparties will exercise their contractual rights in a manner that is inconsistent with the provisions of the U.S. Special Resolution Regimes; (2) QFCs governed by U.S. law from the requirement to opt into the stay-

⁷ The final rule would exclude subsidiaries owned in satisfaction of debts previously contracted in good faith, portfolio companies owned pursuant to merchant banking authority under the BHC Act, portfolio companies owned pursuant a similar investment authority under the BHC Act for insurance companies, as well as certain portfolio companies held pursuant to the Small Business Investment Act and certain entities held as public welfare investments. Subsidiaries held under these authorities generally are temporary, and there are legal restrictions and other limitations on the involvement of the GSIB in the operations of these subsidiaries. Moreover, it is unlikely that the resolution of a GSIB would cause the disorderly unwind of the QFCs of these subsidiaries in a manner that would impair the orderly resolution of the GSIB. Therefore, the impact of these exclusions on systemic risk should be relatively small while responding to commenter concerns and reducing burden.

and-transfer provisions of the U.S. Special Resolution Regimes, as there is no ambiguity that such QFCs would be subject to the stay-and-transfer provisions of the U.S. Special Resolution Regimes; and (3) certain QFCs (e.g., existing warrants and investment advisory agreements with retail customers) that would be difficult to amend. Commenters generally contended that these types of QFCs number in the millions at some firms and that remediating these contracts to include the express provisions required by the final rule would involve an enormous client outreach effort that would be burdensome and costly while providing no meaningful resolution benefits.

In response to comments received on this aspect of the proposal, the final rule would include a number of modifications to the scope of 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 provide default rights, as these QFCs do not have the types of contractual provisions that the rule is intended to address. The final rule would, however, continue to cover QFCs that have transfer restrictions (but no default rights or cross-default rights) because transfer restrictions could impede the orderly resolution of a covered entity or its subsidiary.

The final rule also would exempt any QFC of a covered entity that is with a counterparty organized or domiciled in the United States (a “U.S. counterparty”) and that states that it is governed by the laws of the United States or a state of the United States (“U.S. law”) from the requirement to provide that these QFCs are subject to the stay-and-transfer provisions of the U.S. Special Resolution Regimes. Therefore, this exemption is limited to contracts under which the stay-and-transfer provisions of the U.S. Special Resolution Regimes are clearly enforceable. In addition, the final rule would provide that a covered entity is not required to conform investment advisory contracts with retail customers or an existing warrant evidencing a right to subscribe or

to otherwise acquire a security of a covered entity.⁸ To further address concerns regarding the scope of QFCs, the final rule would provide the Board with authority to exempt additional contract types on a case-by-case basis..

3. Exclusions for Certain QFCs

The final rule, like the proposal, would not apply to QFCs to which a central counterparty (“CCP”) is a party. The final rule also would make clear that where a financial market utility (“FMU”) is the only counterparty to a QFC with a covered entity, a covered entity is not required to conform the QFC to the requirements of the final rule.

A number of commenters urged the Board to exclude the “client-facing leg” of a cleared swap where a clearing member that is a GSIB faces a CCP on one leg of the transaction and faces the client on an otherwise identical offsetting transaction. Commenters contended that not allowing termination of the client-facing leg would result in an unbalanced position for the clearing member in the event of its insolvency or resolution and a customer would be left with a QFC that was intended to be cleared but is not cleared. The final rule would not extend the exclusion for CCPs to the client-facing leg of a cleared transaction because bilateral trades between a GSIB and a non-CCP counterparty are the types of transactions that the final rule is intended to address and because the final rule would not prohibit a covered entity clearing member and a client from agreeing to terminate or novate a trade to balance the clearing member’s exposure.⁹

⁸ Warrants issued after the effective date of the final rule are not excluded from the requirements of the final rule.

⁹ The Universal Protocol exempts from certain of its provisions the client-facing leg of a cleared trade but clients are expected to adhere to the U.S. Protocol. To ensure comparable treatment between the final rule and the U.S. Protocol, the final rule provides that the U.S. Protocol must not exempt the client-facing leg of a cleared transaction.

B. Required Contractual Provisions

1. Required contractual provisions related to the U.S. Special Resolution Regimes

Under the final rule, a covered entity would be required to ensure that its QFCs explicitly provide (1) that the transfer of the 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 QFC can be exercised to no greater extent than they could be under the U.S. Special Resolution Regimes. This provision would require QFCs of covered entities to acknowledge that the transfer provisions and limits on default rights contained in the U.S. Special Resolution Regimes apply to the QFCs, including those entered into outside the United States with foreign counterparties. As explained above, a QFC of a covered entity would be exempt from this requirement if it was with a U.S. counterparty and governed by U.S. law. This element of the final rule would reduce the risk that a counterparty in a foreign jurisdiction would challenge and disregard the stay and transfer provisions of the U.S. Special Resolution Regimes. Financial regulators in other jurisdictions have taken similar actions to ensure the cross-border application of their own special resolution regimes.

2. Prohibited cross-default rights

The final rule would prohibit a covered entity from being party to a QFC that would permit the exercise of a cross-default right (i.e., a default right that is related to the entry into resolution of an affiliate of the covered entity). The final rule 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 cross-default rights would apply to cross-default rights triggered by any insolvency or resolution regimes, such as Title II of the Dodd-Frank Act and bankruptcy.

Notwithstanding the general prohibition, under the draft final rule, 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 under the contract, 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.

The purpose of the draft final rule's prohibition on cross-default rights is to facilitate the orderly resolution of a GSIB under a single-point-of-entry strategy, or another strategy under which some of the failed entity's affiliates continue to meet their obligations and do not enter resolution. The cross-default prohibition accomplishes this goal 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 element of the draft final rule 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 failed firm, and to transfer credit enhancements to a bridge financial company or third party before the end of a stay period.

3. Compliance with Industry Protocols

A covered entity would be able to comply with the requirements of the final rule by amending the contractual provisions of its QFCs directly with its counterparties or by adhering to the Universal Protocol or the U.S. Protocol (together, the "Industry Protocols"). By signing up to the Industry Protocols, market participants can amend their QFCs to restrict the exercise of

default and cross-default rights in a manner similar to that required by the final rule and therefore achieve an outcome similar to that of the final rule.

Commenters urged that the final rule should also provide for a future protocol that would be substantially similar to the existing Universal Protocol except that it would seek to address the specific needs of buy-side market participants, such as asset managers, insurance companies, and pension funds who are counterparties to QFCs with GSIBs. To address these concerns, the final rule safe harbors a new protocol, the U.S. Protocol, which is required to be the same as the existing Universal Protocol but for minor changes intended to address issues that are specific to buy-side market participants.

This safe harbor treatment in the final rule is intended to encourage market participants to amend all of their QFCs by signing up to the Industry Protocols rather than by separately negotiating each contract with each counterparty. While the Industry Protocols include broader creditor protections than would be permitted under the final rule and therefore allow for a somewhat greater risk of destabilizing QFC unwinds, the protocols also have attractive features that the final rule lacks. For example, when a market participant signs up to the Universal Protocol, it must do so with respect to all entities that have signed up and also with respect to all covered transactions, both future and existing. By contrast, the final 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 final rule applies to existing transactions only if and when a GSIB enters new transactions.

4. Procedure for Board approval of enhanced creditor protections

The final rule would permit a covered entity to request that the Board approve as compliant with the final rule's provisions a set of creditor protections that are broader than, or different from, the ones that are permitted by the final 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 final rule's prohibition on cross-default rights. The draft final rule lays out a set of factors that the Board would consider in reviewing such a request. The final rule's approval process would give the Board the flexibility to approve slightly different contractual arrangements without the need for a new rulemaking.

5. Transition period

In order to reduce the compliance burden of the final rule, the final rule would adopt a phased-in compliance date schedule as requested by commenters. The final rule would require a covered entity to conform a covered QFC to the requirements of the final rule on the first day of the calendar quarter immediately following one year from the effective date of the rule ("first compliance date") with respect to covered QFCs with other covered entities. The final rule would provide additional time for compliance with respect to other types of counterparties. In particular, for other types of financial counterparties (other than community banks), the final rule would provide 18 months from the effective date of the final rule for compliance with its requirements. For community banks and non-financial counterparties, the final rule would provide two years from the effective date of the final rule for compliance with its requirements. Similarly, an entity that becomes a covered entity after the final rule is issued would have the same two-year, phased-in compliance schedule based on the type of counterparty. Adopting a phased-in compliance approach based on the type of the counterparty would allow market participants time to adjust to the new requirements and make required changes to QFCs in an orderly manner. It would also give time for development of the U.S. protocol or any other protocol that would meet the requirements of the final rule.

A covered entity would be required to ensure that all QFCs entered into after the first compliance date comply with the rule. A covered entity would not be required to bring QFCs

entered into before that date into compliance unless the covered entity or any affiliate of the covered entity enters into another QFC with the same party or any of its consolidated affiliates on or after the first compliance date.¹⁰ By permitting a covered entity to remain a party to noncompliant QFCs entered into before the first compliance date unless the covered entity enters into new QFCs with the same counterparty or its consolidated affiliate, the final rule would strike a balance between ensuring QFC continuity if the GSIB were to fail and ensuring that covered entities and their existing counterparties can manage any compliance costs and disruptions associated with conforming existing QFCs by refraining from entering into new QFCs.

6. Costs and benefits

Staff believes that the final rule 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 final rule to covered entities and their QFC counterparties would generally be of three types. The first cost would be the cost to QFC counterparties arising from the relinquishment of certain rights, such as cross-default rights, that would have been permitted prior to the rule. However, the costs of restricting such rights are expected to be low as the nature of the rights that are restricted is narrow, the likelihood of exercising such rights is low, and other forms of protection are available that are not prohibited by the rule.

The second cost associated with the rule is the cost of lost revenue for covered entities that might result if non-covered entity counterparties refuse to engage in QFCs with covered

¹⁰ “Consolidated affiliate” is defined in the draft final rule by reference to financial consolidation principles. A number of commenters indicated that burden would be mitigated by defining counterparties by reference to financial consolidation.

entities as a result of the reduction in rights required by the rule. This cost, however, only accrues in the aggregate to the banking system to the extent that non-covered entity counterparties refuse to engage in QFCs with any counterparty.

Third and finally, this rule imposes costs on covered entities and non-covered entities to the extent that they are required to bear legal and administrative costs associated with drafting and negotiating compliant contracts. These costs are expected to be small relative to the costs of doing business in the financial sector generally. Moreover, the final rule explicitly allows for the use of standardized industry protocols in lieu of complying with the terms of the rule, which should reduce the legal and administrative costs associated with complying with the rule.

In developing the final rule, the information regarding costs and benefits provided by commenters has been taken into account. To reduce the overall burden, the draft final rule contains a number of changes to respond to commenter concerns. In particular, the final rule would exclude contracts (such as those with no default rights or transfer restrictions) that commenters argued would be costly to remediate without an attendant benefit to resolution of a GSIB. Additionally, in certain cases, where remediation of contracts would be difficult, the final rule would exclude such existing contracts from the scope of coverage of the requirements of the final rule (e.g., existing warrants and retail investment advisory contracts). The final rule similarly would exclude from the requirements related to the U.S. Special Resolution Regimes contracts with a U.S. counterparty that are governed by U.S. law. Commenters argued that renegotiating these contracts would be burdensome with no benefit to resolution. The final rule would provide a longer transition period for certain counterparties as requested by commenters in order to help mitigate the compliance burden on covered entities. Moreover, the final rule would define an affiliate of a QFC counterparty by reference to financial consolidation principles, which a number of commenters stated would help mitigate burden.

Staff believes that the changes above address many of the 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.

Additionally, the stay-and-transfer provisions of the Dodd-Frank Act and the FDI Act are already in force, and the Universal Protocol is already partially effective. This observation provides further support for the view that any marginal costs that would be created by the final rule—which is intended to extend the effects of the stay-and-transfer provisions and the Universal Protocol—are unlikely to be material.

For all these reasons, 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 create substantial economic benefits. The final rule 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. In addition, the final rule would likely benefit subsidiaries of a failed GSIB, as well as their counterparties and creditors, by helping to prevent the disorderly failure of the subsidiaries and allowing them to continue to meet their obligations. Moreover, non-covered entity counterparties may choose to engage in QFCs with non-GSIB counterparties, in which case revenue that is lost by a GSIB may be recouped by a non-GSIB and aggregate QFC activity by the banking system would not decline.

C. Technical Amendments to Certain Definitions

The final rule 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 final rule 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 Universal Protocol would not cause unintended disruptions to the rules' treatment of netting sets.¹¹

CONCLUSION: Staff recommends that the Board approve the attached draft Federal Register notice and draft final 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. Staff also seeks approval to make conforming, nonsubstantive changes (e.g., to make changes requested by the OCC and FDIC as part of their approval process of substantially similar final rules) and technical and minor changes to the draft Federal Register documents to prepare them for publication.

Attachment

¹¹ 79 FR 78287 (Dec. 30, 2014).