William C Dudley: Panel remarks at The Clearing House Annual Conference

Panel remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at The Clearing House Annual Conference, New York City, 18 November 2015.

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It is a great pleasure to have the opportunity to speak here today alongside my fellow Reserve Bank presidents, Loretta Mester and Dennis Lockhart. Today's event comes almost exactly two years since I delivered a set of remarks at NYU School of Law that covered various aspects of what we know as the "too big to fail" problem. In view of some significant milestones that have occurred over the past two years, I would like today to briefly review my sense of the work that has been accomplished on this critical issue, and the work that still remains to be completed.

As always, what I have to say reflects my own views and not necessarily those of the Federal Reserve System.

Broadly speaking, the regulatory reforms that the U.S. has adopted since the crisis have been designed to address the risks posed by large financial institutions in two related ways. First, our reforms are designed to reduce the probability that large financial institutions will fail by requiring those institutions to be more resilient to stress. Second, a set of resolution-related reforms are intended to limit the consequences to the financial sector if a failure by such an institution still were to occur.

Given the limited time on this panel, I will not review in detail the post-crisis comprehensive capital and liquidity framework that the Federal Reserve has put in place. However, from the perspective of addressing too big to fail, it is important to highlight the Federal Reserve rule finalized this year that imposes risk-based capital surcharges on the handful of U.S. global systemically important banking organizations (GSIBs). Under this framework, a GSIB's risk-based capital surcharge will reflect the degree to which its failure would impact the financial system. In effect, the risk-based capital surcharge confronts each U.S. GSIB with the choice to either reduce its systemic footprint or instead to hold more capital.

The policy approach to too big to fail recognizes, of course, that we can reduce but cannot completely eliminate the possibility of a large financial institution's failure. Therefore, a second aim of our post-crisis reforms has been to limit the adverse consequences that would result if a large financial institution were to fail. That is, large financial firms need to be capable of being successfully resolved without creating unacceptable collateral damage to the rest of the financial system and to the economy.

In my November 2013 speech, I noted that an important foundation for making the resolution of our largest banking firms feasible would be to require, at the holding company level, sufficient minimum amounts of long-term debt that could be used to absorb losses in a single point of entry resolution. Important progress has been made on this front, both in the form of the Federal Reserve's recent issuance of a proposed rule to establish long-term debt and total loss-absorbing capacity (TLAC) requirements for U.S. GSIBs and the announcement last week by the Financial Stability Board (FSB) of an agreed upon international minimum TLAC standard. It is notable that in several important respects the proposed U.S. rules are stronger than the FSB standard.

With these new proposed requirements, if losses were to wipe out a firm's capital and push a firm into resolution, a sufficient amount of long-term unsecured debt would be available to absorb additional losses through a "bail in" process, recapitalizing the firm with no taxpayer bailout and without generating systemic financial contagion. These proposed requirements should also improve market discipline by ensuring that each GSIB has a class of creditors who are clearly "at risk," and therefore have an incentive to monitor the firm's risk-taking.

In my 2013 speech, I also called for further work to address the challenges in a resolution scenario posed by potentially disruptive close-out of cross-border derivatives contracts. Here too, important progress has been achieved over the past two years.

Thanks to productive collective action by the private sector in dialogue with U.S. and international authorities, an initial set of 18 GSIBs and other large dealer banks have adhered to the 2014 International Swaps and Derivatives Association (ISDA) resolution stay protocol covering OTC bilateral derivatives in connection with last year's G-20 summit. Under the protocol, counterparties agreed to the cross-border enforceability of existing statutory stays on resolution-related early termination and other default rights in OTC bilateral derivatives contracts.

With support from the U.S. and other key jurisdictions, the FSB subsequently called on all GSIBs and other firms with significant derivatives exposures to adhere to the protocol by the end of 2015. In addition, the FSB requested that such contractual terms be incorporated into other financial contracts with resolution-related termination features−such as contracts relating to repo and securities lending arrangements. This goal has been accomplished this past week, and represents another positive milestone in improving cross-border resolvability. Importantly, both the proposed U.S. long-term debt requirement and provisions in the resolution stay protocol support resolution under both Title I and Title II of the Dodd-Frank Act.

While we should recognize the extent of progress that has been made to set the basic foundations for the cross-border resolution of a GSIB, it is equally important in my view to recognize the significant challenges that still remain, and the important work that still needs to be carried out by both firms and authorities.

Both within the official sector and within the largest banking firms, important work remains to be done to advance the capacity to effectively operationalize a GSIB resolution.

Examples include:

- establishing a more rational and less complex legal entity structure that takes into account the best alignment of legal entities and business lines to improve the firm's resolvability;
- ensuring the continuity of shared services that support critical operations and core business lines throughout the resolution process; and
- improved arrangements to enable appropriate access by the firm in resolution to Financial Market Infrastructures (FMIs), in a manner that is consistent with the need to ensure the safe and sound operation of FMIs.

This ongoing work is being pursued through a variety of channels, including through the joint Federal Reserve / FDIC review of Title I resolution plans, the Federal Reserve's horizontal supervisory review of recovery and resolution preparedness, and in the international work of the FSB.

In addition, while Title II of the Dodd-Frank Act establishes the FDIC Orderly Liquidation Fund as a source of backstop liquidity provision for a firm undergoing a Title II resolution, no equivalent official sector liquidity backstop is available under the bankruptcy regime. Since it is the bankruptcy regime that is relevant for the purposes of resolution planning under Title I, this is a challenge that firms need to address under that framework.

Further work remains as well with respect to the derivatives close-out issue in resolution. A key next step will be for the U.S. and other major jurisdictions to put in place regulations and supervisory measures that will require non-bank counterparties of GSIBs to trade with the

GSIBs on terms equivalent to those found in the ISDA resolution stay protocol. This further step is needed in order to limit the potential for arbitrage within the market and to promote greater stability in the event of a necessary resolution.

As we move this work forward, we should acknowledge and take stock of the significant advances achieved over the past few years, while at the same time remain focused on our responsibility to address the challenges that remain.

Thank you for your kind attention.