The Systemic Risk Council

December 1, 2014

The Financial Stability Board
Re: Cross-Border Recognition of Resolution Action Document

Dear Financial Stability Board:

We[1] commend the Financial Stability Board for its progress in addressing too big to fail, and in particular, addressing the important cross-border issues that can contribute to systemic instability and impede the orderly resolution of a large financial institution. Important work remains to be done before financial markets, policymakers and the public can feel confident that large, globally active financial institutions will be able to fail without destabilizing markets or needing taxpayer support. We applaud the FSB's recent efforts to secure a protocol for a short stay for derivatives counterparties when bankruptcy courts or resolution entities begin the wind down of a failed large financial institution. We urge the FSB and individual regulators around the world to continue putting in place the policies necessary to protect taxpayers and financial markets from the failure of systemic, global firms.

As we have previously noted to regulators seeking to address the problem of too big to fail in the United States, "the effective resolution [of a large, complex financial institution] is put at risk by existing derivatives contracts that do not reflect the FDIC's authority under Dodd-Frank's Orderly Liquidation Authority to act as receiver."[2]

Even though U.S. law specifically provides a stay for swaps contracts in an "orderly liquidation," U.S. law does not bind foreign counterparties, and many existing cross-border swaps contracts do not specifically recognize that requirement. This creates significant legal and market uncertainty and undermines the ability of the FDIC to avoid market disruptions by requiring derivatives counterparties to continue to perform on their contractual obligations. Similarly, absent contractual changes, a bankruptcy court would be unable to avoid the systemic consequences of a blanket repudiation of a major financial institution's derivatives contracts. This undercuts the Dodd-Frank Act's objective of enabling large financial institutions to credibly fail in bankruptcy. As the Council has previously stated:

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[1] The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed by CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. capital markets focused on systemic risk. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the supporting organizations. The Council works collaboratively to seek agreement on all recommendations. This letter fairly reflects the consensus views of the Council, but does not bind individual members.

[2] Systemic Risk Council Letter to the Federal Deposit Insurance Corporation, Feb. 18, 2014. Available at http://www.systemicriskcouncil.org/wp-content/uploads/2014/02/SRC-Comment-Ltr-to-FDIC-re-SPOE-2-18-14.pdf

"This uncertainty could affect market confidence in a crisis, undermining the FDIC's efforts to sustain the stability of the financial system [and] raises serious questions about a firm's resolution planning and living will compliance. The Dodd-Frank Act requires[3] that designated firms submit living wills that show they can credibly fail, in bankruptcy, without causing systemic risk."

This problem however, is not limited to the United States. Regulators around the world face a similar problem when endeavoring to plan for, or understand, the potential market impact of a large financial institution's failure. Even if jurisdictions succeed in changing their own laws to address the early termination problem for swaps within their borders, they do not know what will happen to swaps with counterparties in other jurisdictions, or swaps subject to other countries' laws. This can dramatically undercut the resolution and bankruptcy planning process essential to market confidence and stability during a failure. It can also create a host of problems, perverse incentives and market distortions before a failure. For example, counterparties that might otherwise engage in a swap within the same legal jurisdiction might have an incentive to simply establish swaps with entities or affiliates in other jurisdictions simply to benefit from the potential legal ambiguity during a crisis.

Given the size and apparent intractability of this problem, we are heartened by the recent announcement of the International Swap Dealers Association (ISDA) that 18 of its largest members have voluntarily agreed to address this problem through changes in their contracts with each other. These 18 financial institutions represent a significant majority of the derivatives contracts. By agreeing to a short, voluntary stay for swaps with each other, they have taken a valuable step in reducing the potential uncertainty and instability should one of them fail – and therefore taken us one step closer to ending too big to fail.

Unresolved issues associated with cross-border resolution are a key source of public skepticism and doubt about whether a large, global financial institution can be allowed to fail without widespread systemic consequences. We applaud the FSB's work to date and encourage it, as well as individual regulators, to continue to address remaining operational and legal issues associated with global failures. In crisis environments, untested legal authority (and the threat of unanticipated legal challenges) can dramatically alter policymakers' choices. It is essential that these issues be resolved so that regulators are fully prepared to protect taxpayers and the public in the event of future crises.

Respectfully submitted,

The Systemic Risk Council
www.systemicriskcouncil.org

[3] The Dodd-Frank Act, Section 165(d)(4).

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