Meeting of the Board of Governors and the Federal Advisory Council
December 2, 2011

Board members: Chairman Bernanke, Vice Chair Yellen, Governor Duke, and Governor Raskin

Council members: Joseph L. Hooley, Vikram Pandit, Bharat B. Masrani, James E. Rohr, Richard D. Fairbank, Daryl G. Byrd, David W. Nelms, Bryan Jordan, Richard K. Davis, Stanley A. Lybarger, and Russell Goldsmith

Summary: Members of the Federal Reserve Board met with the Federal Advisory Council ("the Council"), a statutorily created advisory group that is composed of twelve representatives of the banking industry (one member from each Federal Reserve District). The Council ordinarily meets four times a year to provide the Board with information from the banking industry's perspective. Council members expressed the following concern about regulatory uncertainty:

> Businesses are concerned by the potential impact of the Federal health care law and the regulatory burden that will be created on financial firms by the Dodd-Frank Act. Regulatory uncertainty has contributed to corporate managers relegating business investment to the sidelines while waiting for "the smoke to clear."

One of the Council members also provided the Board members with a paper on the regulation of electronic payments that included the attached excerpt on Regulation HH, Designated Financial Market Utilities.[1] The Board's proposed rulemaking (Docket No. R-1412) implements these provisions of the Dodd-Frank Act.

Attachment

---

[1] The paper was prepared by Oliver Wyman, a consultancy, and is used with permission. Anyone wishing to obtain a copy of the paper should contact Oliver Wyman directly.

7.6. FINANCIAL MARKET UTILITIES/REG HH

Background

Dodd-Frank Title VIII creates the concepts of the "financial market utility" (FMU) and the "systemically important financial market utility" (SIFMU). As discussed in Section 8.2, the Financial Stability Oversight Council (FSOC) can designate any type of financial company as a systemically important financial institution (SIFI) under Title I. It can similarly designate a FMU as a SIFMU under Title VIII.[200] While Title VIII uses similar procedures for SIFMU designation as does Title I for SIFI designation, the substantive criteria for evaluating systemic importance and the specific powers granted to the FSOC are different.

In evaluating an FMU for systemic importance, the FSOC is directed to consider[201]

• The aggregate value of the transactions it processes

• Its aggregate exposure to its counterparties

• Its "relationship, interdependencies, or other interactions" to other FMUs

• The effect of its failure on "critical markets, financial institutions, or the broader financial system"

• Any other factors that it deems appropriate.

The Federal Reserve has responsibility for the prudential standards and supervision of SIFMUs. The scope of these standards may include[202]

• Risk management policies and procedures

• Margin and collateral requirements

• Participant/counterparty default policies and procedures

• The ability to clear and settle financial transactions

• Capital and financial resource requirements

• Other standards as necessary to support the principles of promoting risk management, promoting safety and soundness, reducing systemic risk, and supporting the stability of the financial system.

In addition, the SIFMU examination regime includes the following elements

• The Federal Reserve can obtain any information it needs from a SIFMU, as well as from any FMU as part of determining whether it should be regulated as a SIFMU

• It can block any change to a SIFMU's rules, procedures, or operations that it believes would materially affect its risks

• It shall inspect each SIFMU at least annually

• If a SIFMU uses services provided by other companies, the Federal Reserve can regulate those services to the same extent as it can regulate the SIFMU itself

• The general framework of enforcement mechanisms that apply to depository institutions shall apply to SIFMUs.

200 The FSOC can regulate whole companies as FMUs, as well as the "payment, clearing, or settlement activity" within a larger financial company under Title VIII. For simplicity, we shall use "FMU" and "SIFMU" to refer to both situations
201 Dodd-Frank §804(a)(2)
202 Dodd-Frank §805(c)

The language used in Title VIII is sufficiently expansive that retail payments systems could be regulated as SIFMUs. Nonetheless, its intended purpose seems to be to regulate wholesale payments systems for several reasons

- Dodd-Frank Title VII mandates the clearing of derivatives, thereby lowering the risks borne by derivatives end users, while simultaneously increasing the riskiness and interconnectedness of clearing organizations. In short, Title VII reduces overall risks while concentrating the remaining risk in a few institutions. Title VIII, in turn, manages and mitigates these risks

- Numerous provisions in Title VIII involve the SEC and CFTC, neither of which is involved in retail payments

- Only some of the language used in Title VIII (whose formal name is "Payment, Clearing, and Settlement Supervision") is used in retail payments. Conversely, much of the language and the concepts specific to retail payments (e.g., authorization, merchant processing, etc.) are absent

- Elements of the Federal Reserve's SIFMU prudential supervision regime address concepts that are much more applicable to wholesale payments than retail payments (e.g., counterparty default, collateral requirements).

Similarly, fundamental differences in the size and interconnectedness of retail and non-retail payments markets exist

- In 2009, the Depository Trust and Clearing Company (one of the companies that may be designated as a SIFMU[203]) settled $1.48 quadrillion in securities transactions.[204] This is roughly a thousand times the volume of the card networks

- Tri-party repo outstandings amounted to $2.5 TN pre-crisis.[205] This market is three times larger than card outstandings[206] but consists of only two institutions, which clear all tri-party repos[207]

- Clearing services (for securities, repos, etc.) are inherently systemically risky – the failure of one institution necessarily puts other financial institutions at risk. By contrast, retail payments markets connect financial institutions to customers. If a credit or debit card network (somehow) ceased to function, this would be unlikely to trigger cascading failures of other institutions.

In July 2011, the FSOC approved a final rule[208] establishing the processes and general principles for designating FMUs as SIFMUs.[209] The rule itself does not provide much insight into whether it will designate retail payments systems as SIFMUs, nor does it address the particulars of the enhanced prudential supervision that SIFMUs would face.

---

203 As the DTCC states, "DTCC recognizes that it plays a systemically important role to ensure the continued stable operations of the global clearance and settlement system and the containment and resolution of potential risks within the system" (DTCC Principles of Governance, available at www.dtcc.com/legal/compliance/governance/Principles_of_Governance_DTCC.pdf)
204 Per www.dtcc.com/about/business
205 The volume of tri-party repos outstanding reached a pre-crisis peak of $2.8 TN. Federal Reserve Bank of New York Staff Report number 477, "The Tri-Party Repo Market before the 2010 Reforms," November 2010, p. 17
206 All revolving debt (of which credit cards are the largest component) in April 2008 amounted to $931 BN. Federal Reserve Statistical Release G.19, May 2008
207 Federal Reserve study 477 *supra*, p. 8
208 To be codified as 12 CFR Part 1320. Published in the Federal Register at 76 FR 44763-44776
209 Strictly speaking, the final rule only addresses payment market utilities, not payment, clearing, and settlement activities

By contrast, the FSOC's discussion of the comment letters that it received in response to its March 2011 draft rules is insightful

> *"Within payment systems, the Council expects to focus on FMUs that operate large-value systems and not on FMUs that operate low-value systems for which there appear to be readily available and timely alternative payment mechanisms. However, the Council has decided against including in the final rule any categorical exclusion for FMUs operating retail payment or other systems, both because there are not clear distinctions between various types of systems, and because such an exclusion would impair the Council's ability to respond appropriately to new information, changed circumstances, and future developments. The Council has also decided against including in the final rule a rebuttable presumption that retail payment systems are not systemically important."* [210]

Meanwhile, the Federal Reserve has issued a draft version of what will become Regulation HH, which establishes the risk management standards that shall apply to SIFMUs.[211] The comment period on the draft version of Regulation HH concluded in May 2011.

Implications for alternative payments

It is likely that traditional payment networks will not become SIFMUs. If so, this issue does not create further differences in the treatment of traditional and alternative electronic payments. Nonetheless, the possibility of traditional payment networks being deemed SIFMUs cannot be ruled out. Given the criteria that the FSOC must use, and the smaller volume (at present) of alternative payments, if, say, the card networks become SIFMUs, it is likely that alternatives would not.

As yet, no companies have become SIFMUs, and the FSOC has not spelled out the heighted regulation that SIFMUs will face. It therefore remains speculative as to what a regulatory gap here might entail.

210 76 FR 44769
211 Published in the Federal Register at 76 FR 18445-18454