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PUBLIC INTEREST COMMENT

FINANCIAL MARKET UTILITIES
Docket No: R-1455

By Hester Peirce

Board of Governors of the Federal Reserve System Regulation HH
78 Fed. Reg. 14024
RIN 7100-AD-94

Comment Period Closes May 3, 2013

INTRODUCTION

The Regulatory Studies Program of the Mercatus Center at George Mason University is dedicated to advancing knowledge about the effects of regulation on society. As part of its mission, the program conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals and their effects on the economic opportunities and social well-being available to all members of American society. Thus, this response to the notice of proposed rulemaking regarding financial market utilities by the Board of Governors of the Federal Reserve System (Board) does not represent the views of any particular affected party or special interest group but is designed to assist the Board as it seeks to implement Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

The proposed rules would implement sections 806(a) and (c) of Dodd-Frank, which allow the Board to authorize Reserve Banks to establish and maintain accounts for, provide certain services to,[1] and pay interest on balances maintained by or on behalf of financial market utilities (FMUs) that are designated by the Financial Stability Oversight Council (FSOC) as systemically important or likely to become systemically important.

This public interest comment, which focuses primarily on designated FMUs that are central counterparties (CCPs), raises fundamental concerns about the new regulatory regime for FMUs, the

1. The services are those listed in section 11A(b) of the Federal Reserve Act [12 U.S.C. § 248a(b)]. These services are "(1) currency and coin services; (2) check clearing and collection services; (3) wire transfer services; (4) automated clearinghouse services; (5) settlement services; (6) securities safekeeping services; (7) Federal Reserve float; and (8) any new services which the Federal Reserve System offers, including but not limited to payment services to effectuate the electronic transfer of funds." Ibid.

For more information, contact:
Robin Bowen, (703) 993-8582, rbowen@mercatus.gmu.edu
Mercatus Center at George Mason University
3351 Fairfax Drive, 4th Floor, Arlington, VA 22201

implications of granting these entities bank-like privileges at the Reserve Banks, and the possibility that one or more FMUs will be bailed out at taxpayer expense. Before proceeding with this rulemaking—which is discretionary, yet raises serious policy issues—the Board should take a broader look at the potential risks associated with CCPs under the Dodd-Frank regulatory regime, the resultant potential exposure of the Federal Reserve and US taxpayers to losses, and the need for modifications to the Dodd-Frank framework to control those risks and avert losses.

BACKGROUND AGAINST WHICH THE PROPOSAL MUST BE ASSESSED

Under Title VIII of Dodd-Frank, the FSOC has the authority to designate FMUs that are, or are likely to become, systemically important.[2] These designated FMUs are subject to a heightened regulatory regime and—conditioned on Board authorization—are able to establish Federal Reserve accounts, obtain Federal Reserve services, earn interest on account balances, and avail themselves of discount and borrowing privileges "in unusual or exigent circumstances."[3] The FSOC designated eight FMUs on July 18, 2012.[4] Among the designated FMUs are several that clear securities or derivatives transactions, including Chicago Mercantile Exchange, ICE Clear Credit, and the Options Clearing Corporation.

CCPs, which are commonly referred to as clearinghouses, are cornerstones of Dodd-Frank's over-the-counter derivatives reforms. Dodd-Frank requires many over-the-counter derivatives—swaps and security-based swaps (referred to herein collectively as "swaps")—to be centrally cleared. Proponents of this portion of Dodd-Frank point to its ability to reduce—or at least move to a purportedly safe institution—risk in the large swaps market. By stepping in after a transaction is executed and serving as the buyer to the seller and the seller to the buyer, CCPs eliminate the need for buyers and sellers to take each other's credit and liquidity risk into account. Counterparty risk is normally an important consideration, particularly in long-dated swaps contracts. When a contract is centrally cleared, parties to the transaction need only worry about the creditworthiness of the CCP.

As a consequence of Dodd-Frank's emphasis on central clearing of swaps, CCPs are rapidly assuming the difficult tasks associated with clearing swaps, including gaining an understanding of the risks of complex swaps and swap market participants, collecting appropriate margin, and making any necessary adjustments to guaranty funds. CCPs likely will be bigger, have higher concentrations of risk, and be of greater systemic importance than they were before Dodd-Frank.[5] The consequences of the mandate will become clearer as it takes effect, but it "will alter the behavior of market participants in many dimensions," potentially including "effects on liquidity, capital structure (leverage), risk taking, and risk management decisions of financial and non-financial firms, and on their trading and financing decisions during times of market stress."[6] CCPs' "ability" and "incentives to self-regulate their operations and risk management procedures" are likely to suffer.[7]

In response to these changes, Dodd-Frank also places renewed emphasis on regulatory oversight of CCPs. Depending on the type of products they clear, CCPs register with the Commodity Futures

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2. Dodd-Frank § 804(a).

3. Dodd-Frank §§ 805 and 806.

4. See US Department of the Treasury, *Financial Stability Oversight Council Makes First Designations in Effort to Protect Against Future Financial Crises* (Washington, DC, July 18, 2012) (designating The Clearing House Payments Company, L.L.C., on the basis of its role as operator of the Clearing House Interbank Payments System; CLS Bank International; Chicago Mercantile Exchange, Inc.; The Depository Trust Company; Fixed Income Clearing Corporation; ICE Clear Credit LLC; National Securities Clearing Corporation; and The Options Clearing Corporation), http://www.treasury.gov/press-center/press-releases/Pages/tg1645.aspx.

5. Christian Chamorro-Courtland, "The Trillion Dollar Question: Can a Central Bank Bail Out a Central Counterparty Clearing House Which Is 'Too Big to Fail'?," *Brooklyn Journal of Corporate, Financial & Commercial Law* 6, no. 2 (2012): 433, 437.

6. Craig Pirrong, *The Economics of Central Clearing: Theory and Practice*, ISDA Discussion Paper Series No. 1 (May 2011), at 6.

7. Chamorro-Courtland, "Trillion Dollar Question," 434.

Trading Commission (CFTC) as derivatives clearing organizations or with the Securities and Exchange Commission (SEC) as clearing agencies. Dodd-Frank gave the SEC and CFTC substantial authority to regulate and examine the clearinghouses within their ambit. The Board has backup authority over designated FMUs for which the SEC and CFTC serve as primary regulators.

PROPOSED RULE

The proposed rulemaking relies on permissive authority in Dodd-Frank to amend Regulation HH to allow Federal Reserve Banks to enter into agreements pursuant to which a designated FMU could have an account at and receive services and interest from the Reserve Bank. These privileges, which were previously limited to depositories, would allow FMUs to reduce their reliance on settlement banks.[8] The proposed rule conditions the authority to extend such privileges to an FMU on the Reserve Bank's "ensur[ing] that its establishment and maintenance of an account for or provision of services to a designated financial market utility does not create undue credit, settlement, or other risk to the Reserve Bank" and requires the FMU to, in the Federal Reserve Bank's judgment

> 1. be generally in sound financial condition;
>
> 2. be in compliance, based on information provided by the Supervisory Agency, with requirements imposed by its Supervisory Agency regarding financial resources, liquidity, participant default management, and other aspects of risk management;
>
> 3. be in compliance with [Board and Reserve Bank requirements regarding accounts and services]; and
>
> 4. demonstrate an ongoing ability, including during periods of market stress or a participant default, to meet all of its obligations under its agreement . . . [9]

With respect to swaps CCPs, these conditions will entail coordination between the Federal Reserve Banks and the CFTC or SEC, but will also allow the Reserve Banks to exercise a measure of independent discretion.

The Board's stated objectives in the proposed rulemaking are "reducing settlement and systemic risks and strengthening the settlement processes of designated FMUs through the use of Reserve Bank accounts and services, while limiting risk to the Reserve Banks."[10] The Board requested comment about whether additional conditions are necessary to achieve these objectives "while limiting risk to the Reserve Banks."[11] Rather than looking only at whether and how to modify the list of conditions on account access, the Board should undertake a broader review of the potential implications of the new relationship between FMUs and the Federal Reserve, of which this proposal is one piece.

NEED FOR REGULATORY IMPACT ANALYSIS

The need for a thorough regulatory analysis in connection with this proposal stems from the marked shift it reflects in the availability of Federal Reserve resources to FMUs. Indeed, in the notice, the Board acknowledged that "the establishment of an account for a designated FMU at a Reserve Bank

8. For a discussion of the effect that having an account at a Reserve Bank would have, see Anna L. Paulson and Kirstin E. Wells, "Enhancing Financial Stability: The Case of Financial Market Utilities," *Chicago Fed Letter* No. 279 (Oct. 2010): 3, http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2010/cfloctober2010_279.pdf.

9. Proposed § 234.6(b).

10. 78 Fed. Reg. 14024 at 14026.

11. 78 Fed. Reg. 14024 at 14028.

also may entail broader policy considerations and implications."[12] Nevertheless, the notice made no mention of a regulatory analysis, something that the President has encouraged independent regulatory agencies to undertake[13] and something that Board policy requires.[14] Specifically, the Board's policy requires a regulatory analysis for all nontechnical regulations that do not need to be expedited.[15] The notice did not include any indication that this is an expedited rulemaking, and, because of its discretionary nature, this is not the type of rulemaking that would be expedited under the Board's policy statement.

Given the policy implications and potential risk to the Reserve Banks, there is good reason not to expedite this rulemaking but instead to conduct an exhaustive regulatory analysis of the sort envisioned by the Board's policy statement. The policy statement calls specifically for the analysis to "discuss the need for and purposes of the regulation, set forth the various options available, discuss, where appropriate, their possible economic implications, evaluate their compliance, recordkeeping, and reporting burdens, and recommend the best course of action based on an evaluation of the alternatives."[16]

An analysis of the proposed rule should include a consideration of the costs and benefits—including Federal Reserve exposure to losses[17] and competitive impacts[18]—of allowing designated FMUs to have accounts at Reserve Banks and avail themselves of services provided by Reserve Banks. In addition, it should look at the broader implications of transforming the relationship between the Federal Reserve and designated FMUs. Conducting such an analysis would help the Board, Congress, the President, and the public to understand the implications of the proposed rulemaking in the post-Dodd-Frank environment of swap clearing mandates.

CCP VULNERABILITY AND FEDERAL RESERVE RESCUES

There is wide agreement that the ramifications of a CCP experiencing difficulties would be felt throughout the financial system. CCPs will house a lot of risk and have relationships with a lot of significant financial institutions. The inability of a CCP to meet its obligations would be most likely to occur, and the consequences would be most devastating, during a time of systemic financial stress. Title VIII of Dodd-Frank allows the Federal Reserve to come to the aid of CCPs and other designated FMUs, but the scope and exact nature of the help that it could provide remains murky and subject to Board interpretation. Accordingly, the Board's rulemaking regarding

12. 78 Fed. Reg. 14024, n.7 (Mar. 4, 2013).
13. Exec. Order No. 13579, 76 Fed. Reg. 41587 (July 14, 2011), http://www.gpo.gov/fdsys/pkg/FR-2011-07-14/pdf/2011-17953.pdf. In this executive order, the president calls on independent regulatory agencies to follow the rulemaking principles governing executive agencies.
14. Board of Governors of the Federal Reserve System, Statement of Policy Regarding Expanded Rulemaking Procedures, 44 Fed. Reg. 3957 (1979).
15. Ibid., 3958.
16. Ibid., 3958.
17. The proposed rule leaves the Reserve Banks open to losses from, for example, an overdraft. See Colleen Baker, "The Federal Reserve's Supporting Role Behind the Dodd-Frank's Clearinghouse Reforms," *Harvard Business Law Review Online* 3, No. 177 (April 20, 2013): 181–2. Baker notes that "these reforms create a potentially significant risk for the Federal Reserve Bank" and cites the fact that the proposed rule does not appear to prohibit coverage of an inadvertent overdraft." Id. at 181–2 and n. 35. Reserve Banks also might incur losses if, as one commenter urged, the Board were to direct the Reserve Banks "to continue to provide services . . . in times of severe market stress without regard to the [FMU's] compliance with other requirements if the Board determines that such action is necessary to avoid a crisis of confidence in the financial system." James E. Brown (Executive Vice President, General Counsel and Secretary, The Options Clearing Corporation) to Robert deV. Frierson (Secretary, Board of Governors of the Federal Reserve System) 25 April 2013, at 3, http://www.federalreserve.gov/SECRS/2013/April/20130426/R-1455/R-1455_042513_111086_560435838504_1.pdf.
18. In its comment letter, The Clearing House noted one potential competitive impact. It raised concerns about granting the Reserve Banks access to confidential supervisory information about FMUs that compete with them in the provision of services. Alexander to DeV. Frierson, 3–4, http://www.federalreserve.gov/SECRS/2013/April/20130426/R-1455/R-1455_042613_111085_560436463532_1.pdf.

FMUs' access to Federal Reserve assistance must be undertaken only after careful consideration of the consequences for markets and for taxpayers.

In a 2011 speech, Chairman Bernanke observed that "the failure of, or loss of confidence in, a major clearinghouse would create enormous uncertainty about the status of initiated transactions and, consequently, about the financial positions of clearinghouse participants and their customers."[19] He noted that CCPs performed well during the last crisis, but cautioned that "we should not take for granted that we will be as lucky in the future."[20] Bernanke emphasized the need for coordination among regulators and strong public and private monitoring of clearinghouse risk management. Mr. Bernanke takes the position, however, that even with a strong regulatory structure in place, the Federal Reserve has a role to play in supporting CCPs during times of system-wide stress. Indeed, the Federal Reserve has done this in the past, albeit without the tools given to it by Dodd-Frank. As Bernanke described in an article that looked at clearing during the October 1987 stock market crash, the "Federal Reserve played a vital role in protecting the integrity of the clearing and settlement system during the crash."[21] He explained that "conceptually, it is as if the Fed had provided ex post insurance to the clearinghouse against a shock that it seemed possible would exhaust the insurance capability of the clearinghouse itself. Thus the Fed became the 'insurer of last resort.'"[22] Rather than vainly attempting to completely armor CCPs, Bernanke suggested that "the government, especially the central bank, should be thought of as part of the system [that] protects the clearing and settlement systems, should they be in danger."[23]

The proposed rulemaking takes a significant step towards ensuring that the Federal Reserve will be considered part of the clearing and settlement system. Opening up the opportunity for designated FMUs to establish accounts at and receive services from the Reserve Banks, privileges previously generally limited to depository institutions, would blur the line between FMUs and banks and thus make it easier for the Federal Reserve to provide support to these institutions without public notice or accountability.[24] Dodd-Frank also permits the Federal Reserve to provide "discount and borrowing privileges" in "unusual or exigent circumstances."[25] There is no mention of a requirement that the FMU provide good collateral in connection with discount window access.[26] Moreover, the fact that access can be granted in unusual or exigent circumstances suggests that it may be available even during nonemergencies.[27] Even if the Federal Reserve's role is limited to providing liquidity to a temporarily

19. Ben S. Bernanke (Chairman, Board of Governors of the Federal Reserve System), "Clearinghouses, Financial Stability, and Financial Reform," Speech at the 2011 Financial Markets Conference, Stone Mountain, Georgia (Apr. 4, 2011), http://www.federalreserve.gov/newsevents/speech/bernanke20110404a.htm.

20. Ibid.

21. Ben S. Bernanke, "Clearing and Settlement During the Crash," *The Review of Financial Studies* 3, no. 1 (1990): 133, http://www.bu.edu/econ/files/2012/01/Bernanke-RFS.pdf.

22. Ibid., 149–50.

23. Ibid., 145–46.

24. As the Board has explained elsewhere, "in order to carry out its responsibilities as central bank, the Federal Reserve frequently provides payment services to troubled depository institutions that other providers of payment services may not serve because of the risks involved. This helps to ensure that the inability of a depository institution to make or process payments will not trigger its insolvency and that the institution's problems can be resolved in an orderly fashion with minimum disruptive effects." Board of Governors of the Federal Reserve System, "Federal Reserve's Key Policies for the Provision of Financial Services: The Federal Reserve in the Payments System" (1990), http://www.federalreserve.gov/paymentsystems/pfs_frpaysys.htm. Similar assistance would presumably be made available to troubled FMUs.

25. Dodd-Frank § 806(b).

26. Chamorro-Courtland, "Trillion Dollar Question," 464. Chamorro-Courtland discusses the difficulties of interpreting the effect of this provision that are unique to CCPs. Ibid., 46–67. These are issues that the Board should assess.

27. Colleen Baker makes this point. She explains that the use of "or" instead of "and" distinguishes this language from the more typical term in banking regulation and contends that "almost any type of financial disruption or distress could arguably constitute at least an 'unusual,' if not 'exigent' circumstance—in other words, any circumstance other than business as usual." Colleen Baker, "The Federal Reserve as Last Resort," *University of Michigan Journal of Law Reform* 46 (2012): 69, 110.

cash-strapped clearinghouse, as Craig Pirrong has observed, "ostensible liquidity support could be in fact a bailout of an insolvent institution."[28] Given the highly international nature of the swaps markets and the clearinghouses that serve them, the Federal Reserve could even end up rescuing a non-US entity.[29] Together, the proposed rule and the open-ended potential for discount window access "constitute a potentially significant, explicit expansion of the federal safety net."[30] This expansion merits public discussion.

Although some observers strongly support central bank backing of CCPs,[31] the costs and benefits of the central bank's serving as insurer of last resort for clearinghouses deserve further consideration. Given that this proposed rulemaking would begin the transformation of the Federal Reserve's relationship with designated FMUs, the Board should undertake that consideration in connection with this rulemaking. It should do so in light of the emerging and already troubled regulatory structure for swaps CCPs.

OBSTACLES TO EFFECTIVE REGULATION

The prospect of the Federal Reserve's coming to the rescue at a time of trouble creates moral hazard. A CCP will take more risks, and its members will be less careful, because they understand that the CCP has the ultimate backing of the government.[32] By laying the groundwork for Federal Reserve involvement when things go wrong, Dodd-Frank thus undermines the clearinghouse's own incentives for prudent risk management.[33] Dodd-Frank attempts to address this by providing for intense regulatory oversight, but there are numerous barriers to the success of regulatory endeavors to manage clearinghouse risk.

First, regulators are driven by considerations other than safety and soundness in their regulation of CCPs. There is intense pressure on regulators to move more derivatives into CCPs, and correspondingly less emphasis on safety and soundness of CCPs.[34] Regulators are also less likely to ensure that CCPs carefully assess the risks associated with the new products and the dynamic correlations among different products that CCPs clear. In addition, regulators are under pressure to make CCPs broadly accessible,[35] which could increase CCPs' exposure to risky clearing members.

Second, the CFTC and SEC do not have strong histories of CCP oversight and may be continuing that

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28. Craig Pirrong, *The Economics of Central Clearing: Theory and Practice*, ISDA Discussion Paper Series No. 1 (May 2011), 39.
29. Baker, "The Federal Reserve's Supporting Role," 186. Baker discusses the global nature of clearinghouses and predicts that "the potential problems associated with a central bank's last resort lending to a systemically significant domestic clearinghouse would be multiplied in lending to an overseas clearinghouse over which it has no direct regulatory, supervisory, or enforcement powers."
30. Baker, "The Federal Reserve as Last Resort," 112.
31. See, for example, Jeremy C. Kress, "Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity," *Harvard Journal on Legislation* 48, No. 1 (2011): 49; Chamorro-Courtland, "Trillion Dollar Question," 437.
32. See, for example, Craig Pirrong, *The Economics of Central Clearing: Theory and Practice*, ISDA Discussion Paper Series No. 1 (May 2011), at 14 and 39.
33. Baker, "The Federal Reserve's Supporting Role," 184. Baker explains that "the very presence of a potential central bank backstop for systemically significant clearinghouses—essentially the possibility of catastrophic liquidity insurance—creates a significant moral hazard." Likewise, Chamorro-Courtland explains that "after the new reforms are implemented at the domestic level, CCPs will no longer have the ability or the necessary incentives to self-regulate their operations and risk management procedures." Chamorro-Courtland, "Trillion Dollar Question," 434.
34. As one example, Dodd-Frank requires CCPs to have financial resources sufficient to cover the failure of only the clearing member whose default would create the largest financial exposure for the CCP in extreme but plausible market conditions, rather than the more stringent international standard that resources be sufficient to cover the default of the two clearing members whose default would cause the largest exposure. Compare Dodd-Frank § 725(c) (adding 7 U.S.C. 7a-1(c)(2)(B)(ii)) with CPSS-IOSCO, Principles for Financial Market Infrastructures (Apr. 2012), at Principle 4, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf.
35. See, for example, Christine A. Varney (Assistant Attorney General, Department of Justice, et al.) 28 December 2010, http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26809&SearchText=. Varney argues, among other things, that anticompetitive objectives "could be explained away . . . by expressing risk management-related concerns." Ibid., 8.

tradition. Recently, for example, CFTC Chairman Gary Gensler told the Senate Agriculture Committee that "we're also not doing the examinations that we really should be doing of the clearinghouses . . . we do not have staff examining clearinghouses annually for their risk management and we're pushing—statutorily pushing—all sorts of additional transactions into clearinghouses."[36]

Finally, there are significant barriers to effective regulatory coordination. Dodd-Frank includes a provision that prohibits the CFTC from sharing information about CCPs with another regulator without an indemnification agreement from the other regulator.[37] Ongoing disputes with international regulators about the proper reach of US regulatory authority have further complicated regulatory coordination.[38]

The discretionary element in the proposed rule enables the Reserve Banks to supplement risk management requirements imposed by the relevant supervisory agency. In this sense, the proposed rule may represent something of an end-run around Dodd-Frank's allocation of primary regulatory responsibility over CCPs to the CFTC and the SEC.[39] The authority to make this type of change in the regulatory oversight of CCPs rests with Congress. A thorough regulatory analysis in connection with the proposed rule would look at whether obstacles to sound regulation of CCPs increases the risk that the Federal Reserve would incur losses in connection with exercising its authority to grant bank-like privileges to CCPs.

CONCLUSION

In the midst of the debate about whether Dodd-Frank has solved the too-big-to-fail problem, little attention has been paid to Title VIII's role in establishing a set of too-important-to-fail entities with a government backstop.[40] The notice of proposed rulemaking raises the issue of what kind of Federal Reserve support is appropriate for CCPs that the FSOC has deemed to be systemically important. It does so without asking—or allowing the public to comment on—basic questions about the particular proposal, let alone more fundamental questions about the costs and benefits of installing the Federal Reserve as ex ante insurer of last resort to CCPs. Before proceeding, the Board should look at these questions. It should consider what the problem is that it is trying to solve and whether making Federal Reserve accounts and services available to designated FMUs solves that problem more effectively than alternatives would. One alternative is revisiting the regulatory structure put in place by Dodd-Frank, a structure that is causing CCPs to take on—without time for adequate deliberation—extensive and perilously complicated risks, risks that could ultimately be borne by taxpayers.

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36. Gary Gensler (Chairman, CFTC), Testimony Before the Senate Committee on Agriculture, 27 February 2013, hearing video available at http://www.ag.senate.gov/hearings/oversight-of-the-commodity-futures-trading-commission (at approximately hour 1:27 and 1:41).
37. Dodd-Frank § 725 (adding 7 U.S.C. 7a-1(k)(5)).
38. For example, foreign officials recently wrote to Treasury Secretary Lew to express "concern at the lack of progress in developing workable cross-border rules as part of reforms of the OTC derivatives market." Guido Mantega (Minister of Finance, Government of Brazil) et al., to Jack Lew (Secretary, US Treasury), 18 April 2013, http://www.fsa.go.jp/en/news/2013/20130419.html.
39. Dodd-Frank § 805(a)(2).
40. The issue of the FMUs' status as the newest too-big-to-fail beneficiaries of the federal safety net was discussed in Gretchen Morgenson, "One Safety Net that Needs to Shrink," *New York Times*, November 3, 2012, http://www.nytimes.com/2012/11/04/business/one-safety-net-that-needs-to-shrink.html?_r=0; Hester Plumridge, "What If a Clearing House Failed," *Wall Street Journal*, December 2, 2011.