Notre Dame Law School
NDLScholarship

Journal Articles Publications

2011

Charting a Course in Clearing

Colleen Baker
Notre Dame Law School, cbaker5@nd.edu

Follow this and additional works at: https://scholarship.law.nd.edu/law_faculty_scholarship

Part of the Law and Economics Commons

Recommended Citation
Colleen Baker, *Charting a Course in Clearing*, Bull. Of the Notre Dame Ctr. for the Study of Fin. Regul., Spring 2011, at 5..
Available at: https://scholarship.law.nd.edu/law_faculty_scholarship/1118

This Article is brought to you for free and open access by the Publications at NDLScholarship. It has been accepted for inclusion in Journal Articles by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

UNIVERSITY OF
NOTRE DAME

THE LAW SCHOOL

CHARTING A COURSE IN CLEARING

DR. COLLEEN M. BAKER
Associate Professor of Law,
concurrent Assistant Professor of
Finance in the Mendoza College of Business

Notre Dame Law School
Legal Studies Research Paper No. 11-18

This paper can be downloaded without charge from
the Social Science Research Network electronic library at:
http://ssrn.com/abstract=1810835

A complete list of Research Papers
in this Series can be found at:
http://www.ssrn.com/link/notre-dame-legal-studies.html

Electronic copy available at: http://ssrn.com/abstract=1810835

Charting a Course in Clearing

[Note: a version of this piece is forthcoming in the Bulletin of the Notre Dame Center for the Study of Financial Regulation, Spring 2011]

Memorable tales of financial collapse, such as that of Lehman Brothers (Lehman), Bear Stearns, and American Financial Group (AIG), frequently drive narratives of financial market crises and future preventative regulatory solutions. Much U.S. financial regulation, such as the monumental and historic "Dodd-Frank Wall Street Reform and Consumer Protection Act,"[1] (Dodd-Frank) can be understood from this perspective. Aspects of such responses, however, are sometimes puzzling. An example is the reforms surrounding certain financial market utilities in Dodd-Frank's Title VIII, "Payment, Clearing, and Settlement Supervision Act of 2010" (Title VIII). Financial market utilities often play a vital role in a process known as "payment, clearing and settlement," which occurs after a financial trade is made. Title VIII authorizes the Federal Reserve Board (Fed), in consultation with the Treasury Department, to extend "discount and borrowing privileges only in unusual or exigent circumstances"[2] to financial market utilities designated[3] by Dodd-Frank's new Financial Stability Oversight Council as "systemically important" or of "systemic importance." That is, to provide an emergency funding backstop to such financial utilities. The Fed's new emergency authority is additional to and separate from its "13(3)" emergency powers reformed by Dodd-Frank.[4]

What little attention has so far focused on Title VIII analyzes the Fed's new authority in relation to over-the-counter (OTC) derivatives, especially credit default swaps (CDS). The actual scope of financial contracts for which this new authority is relevant, however, is quite vast: it includes *any* financial transactions using designated financial utilities. Therefore, Title VIII's financial utility reforms are relevant not only to OTC derivatives, but also potentially to repurchase agreements (repos),[5] and any other "financial transactions" that use designated financial utilities now or in the future. On the one hand, these reforms purport to be a critical component in "solving" the AIG problem, but this conclusion is uncertain. On the other hand, these reforms lay the groundwork for alleviating the problem of Lehman and Bear Stearns, but fall short of achieving a potential solution. For these reasons, I suggest[6] that Title VIII's

[1] The Act is electronically available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.
[2] §806(b) of Dodd-Frank.
[3] *See* §804 of Dodd-Frank. These designations will be made by Dodd-Frank's newly created Financial Stability Oversight Council. Such designations should be made this year. *See* Silla Brush, *Gensler Wants Decision Mid-Year on Derivatives Clearinghouses*, Bloomberg, Nov. 23, 2010.
[4] Dodd-Frank amends the Fed's 13(3) emergency powers in Title 11, Federal Reserve System Provisions.
[5] In a May 2010 white paper, the Federal Reserve Bank of New York solicited comments upon the use of a central counterparty clearinghouse in the repo markets. *See* Tri-Party Repo Infrastructure Reform, *available at* http://www.newyorkfed.org/banking/nyfrb_triparty_whitepaper.pdf.
[6] In a working paper, I expand upon the ideas in this piece, including an analysis of the expansive scope of the financial utility reforms in Title VIII, the Fed's new emergency authority contained therein, potential implications of these reforms in the OTC derivative and repo markets, and several suggestions for "reforming the reforms."

Electronic copy available at: http://ssrn.com/abstract=1810835

financial utility reforms both go too far in theory in addressing the "AIG problem," but not far enough in practice in addressing the "Bear Stearns and Lehman problem."

Payment, clearing, and settlement systems perform one of the most vital roles in the financial markets because they provide the system's essential "plumbing." This makes the financial utilities involved, such as central counterparty clearinghouses (CCPs), fundamental to market stability. The payment, clearing, and settlement process occurs within days for securities, but can stretch out over years for OTC derivatives, making the creditworthiness of one's counterparty a central concern in the latter case. Not surprisingly, large or highly connected financial utilities such as CCPs are important sources of potential systemic risk.

A CCP often plays an integral role in the story of what happens after a trade is made and before its final settlement occurs. A CCP "steps" into the middle of a trade through a legal process called "novation" in which the CCP becomes the buyer to the seller and the seller to the buyer in each financial contract. Because it is on both sides of the trade, the CCP's market risk should be flat. It is concern about counterparty credit risk, the risk that one's counterparty will default or become insolvent during the payment, clearing and settlement process, which primarily motivates the use of CCPs, which are highly concentrated centers of credit risk. Not surprisingly, therefore, CCP organizational design is centered on robust risk management practices. In theory, and nearly always, CCPs remove counterparty credit risk for market participants. In rare moments of extreme economic distress, however, CCPs themselves have both flirted with and experienced collapse.[7] Such moments are precisely when the Fed's emergency backstop authority will be important.

Lax risk management practices led to moments of spectacular collapse during the recent financial crisis. In September 2008, AIG faced imminent financial collapse as its CDS counterparties demanded collateral payments it could not meet. Prior to the onset of the financial crisis, these counterparties had rested secure in the guarantee provided by the AIG parent. Without emergency financial assistance from the U.S. government, AIG would have collapsed. To prevent future "AIGs," reforms in Dodd-Frank mandate that all standardized derivatives, including CDS, use a CCP to increase regulatory transparency and to strengthen risk management practices. But not only is it unclear that AIG's CDS were "clearing eligible,"[8] but it also seems likely that the lax risk management practices stemmed from the comfort of a deep-pocketed parent guarantor. The reason Title VIII's financial utility reforms go too far in theory is because they risk replicating this "guarantor dynamic" by potentially creating an important

---

[7] *See* Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 Harv. J. on Legis. 49 (Winter 2011).

[8] Finance experts such as Professor Darrell Duffie at Stanford University note that AIG's problematic CDS were not "standardized," so a CCP "solution" would have been inapplicable in AIG's case. *See* Darrell Duffie, *How Should We Regulate Derivatives Markets?* (PEW Fin. Reform Project, Briefing Paper No. 5, 2009), *available at* http://www.pewfr.org/project_reports_detail?id=0017. Note that what percentage of the OTC derivative markets will ultimately be sufficiently standardized and, therefore, "clearing eligible" remains unclear.

Electronic copy available at: https://ssrn.com/abstract=1810835

moral hazard that risks replacing one deep-pocketed guarantor – the AIG parent – with another – the U.S. government.

In September 2008, without a U.S. government rescue or guarantee, Lehman collapsed and filed for the largest bankruptcy in U.S. history. Finance scholars have termed the proximate cause of both Lehman and Bear Stearns' breakdowns as a "run on repo,"[9] a phenomenon analogous to an old-fashioned bank run, but occurring in the repo markets. Repos are part of what is known as the "shadow banking system," which has many similarities to, engages in many of the same functions as, and shares many of the vulnerabilities of the highly regulated banking system.[10] Prior to the financial crisis, the shadow banking system was – and largely remains – an unregulated, non-transparent arena. In a repo transaction, a "lender" and "borrower" enter into two simultaneous agreements. First, the borrower "sells" securities to the lender. Second, the borrower agrees to "buy back" those securities in the future at a slightly higher price. The difference between the price the lender originally "paid" for the securities and the price the lender is able to resell them for is known as the "repo rate."

Most repos are "overnight," meaning that the parties daily elect to reenter the transaction or "rollover" the debt. Consequently, heavy reliance upon repo financing by borrowers such as Lehman or Bear Stearns can result in a very serious funding shortage in a very short time. Prior to its collapse, Lehman relied upon approximately $200 billion in overnight repos.[11] Curiously, neither financial regulatory reform discussions nor Dodd-Frank focused much attention on the repo markets. Title VIII's financial utility reforms provide the emergency authority to backstop a financial utility for repos. Congress should address repo market reform. Reforming the repo markets could take various approaches,[12] but should provide additional regulatory transparency, strengthened risk management and collateral practices, and improved market structure.[13]

In sum, although in theory, the Fed's new emergency authority created in Title VIII to backstop systemically important financial utilities should be removed because it introduces an important moral hazard, in practice, this authority is necessary because financial regulators are unlikely to allow a systemically significant financial utility, such as a CCP, to fail. Assuming this is the case, the potential government backstop or "liquidity option" available to designated financial utilities in emergency situations should be explicitly recognized and "purchased" by

[9] *See* Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo* (Yale ICF Working Paper No. 09-14, Nov. 9, 2010), *available at* SSRN: http://ssrn.com/abstract=1440752.
[10] For additional discussion of the "shadow banking system," see Viral V. Acharya & T. Sabri Öncü, *The Repurchase Agreement (Repo) Market*, *in Regulating Wall Street* (2010).
[11] As the name implies, "overnight" repos require lenders to daily reenter the transaction or "rollover" the debt. *See* Linda Sandler, *Lehman Had $200 Billion Overnight Repos Pre-Failure*, Bloomberg, Jan. 28, 2011.
[12] Various approaches to repo market reforms have been suggested, some including the use of a financial utility-like entity. For various reform examples, *see* the "repo banks" proposed by Gary B. Gorton and Andrew Metrick in *Regulating the Shadow Banking System* (Oct. 18, 2010), *available at* SSRN: http://ssrn.com/abstract=1676947, or the "repo resolution fund" proposed by Acharya and Öncü, *see supra* note 10.
[13] J.P. Morgan Chase and Bank of New York Mellon are the two main clearing banks in the tri-party repo markets.

Electronic copy available at: https://ssrn.com/abstract=1810835

market participants. Underpriced risk played a fundamental role in the financial crisis.[14] Ultimately, Title VIII's financial utility reforms highlight the need for additional discussion about the provision of such public "options" or "backstops" because the vast majority of all trading activity depends upon financial utilities such as CCPs.

[14] See Professor Raghuram Rajan's discussion of the role of underpriced risk in the financial crisis in his recent book: *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (2010).

Electronic copy available at: https://ssrn.com/abstract=1810835