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Financial Institutions Regulation Group Client Alert: "Financial Market Utilities: the Unintended Consequences of H.R. 10, the Financial CHOICE Act, or It is key to be a QCCP under Basel 3"

On June 8, 2017, the House of Representatives passed H.R. 10, the Financial CHOICE Act of 2017 ("H.R. 10").[1] Subtitle D, entitled "Eliminating Financial Market Utility Designations," includes a section ("Section 141") which would repeal Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA") "as if such title had never been enacted."[2] This repeal is consistent with other sections of H.R. 10, which repeal the provisions of the DFA that give the Financial Stability Oversight Counsel ("FSOC") its ability to make systemic designations of individual non-bank entities or market utilities.[3]

The ability of FSOC to make designations has been caught up in political battles related to the fate of the DFA.[4] However, it is unclear whether such political concerns, which have focused on the ability of FSOC to designate individual non-banks considered systemically important such as GE Capital, AIG, Prudential or MetLife, really have anything to do with the ability of FSOC to designate (and the Board of Governors of the Federal Reserve System (the "Federal Reserve") to regulate and supervise) systemically important financial market utilities such as payment, settlement and clearing systems.

[1] H.R. 10, the Financial CHOICE Act of 2017, 115th Congress (June 8, 2017). https://www.congress.gov/115/bills/hr10/BILLS-115hr10rfs.xml.
[2] Pub.L. 111-203, H.R. 4173 (July 21, 2010).
[3] *See* Subtitle E of H.R. 10, Section 151.
[4] *See, e.g.,* opinion pieces on the fate of FSOC such as https://www.wsj.com/articles/a-choice-for-wall-street-1496964390.

On July 12, 2012, FSOC designated eight financial market utilities ("FMUs") as systemically important.[5] Among those FMUs are several central counterparties ("CCPs") that clear derivatives; by virtue of their designation by FSOC, such CCPs are considered to be qualifying CCPs ("QCCPs") for purposes of the Basel 3 capital requirements. All FMUs also gained access to account services from the Federal Reserve.

As noted, H.R. 10 would delete the ability of FSOC to make such designations and repeal any designations made prior to the date of enactment. If these CCPs are no longer "Q"s, banking entities subject to Basel 3 will be required to hold significantly higher additional capital with respect to their trading, margin and collateral exposure to those CCPs. Further, FMUs would lose their ability to transact directly with a Federal Reserve Bank. These potential changes have caught the attention of at least one Governor of the Federal Reserve.[6]

This article reviews the unintended consequences that would follow for such FMUs and their bank members if H.R. 10 becomes law as it is written.

WHAT DOES TITLE VIII OF THE DFA DO?

Title VIII of the DFA was enacted to mitigate systemic risk in the financial system and to promote financial stability through enhanced supervision of FMUs.[7] According to the Federal Reserve, a failure of or disruption to the functioning of an FMU could create or increase the risk that financial instability would spread among financial institutions or markets and threaten the stability of the U.S. financial system.[8] Under Title VIII, the Federal Reserve may:

- prescribe risk-management standards for certain designated FMUs;
- conduct examinations of and take enforcement actions against certain designated FMUs, and consult on other examinations of FMUs
- receive, review and consult on certain rule notices ("material notices") from designated FMUs;

[5] *See* https://www.treasury.gov/initiatives/fsoc/Documents/2012%20Appendix%20A%20Designation%20of%20Systemically%20Important%20Market%20Utilities.pdf.
[6] *See* https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm ("Powell Speech").
[7] *See* https://www.federalreserve.gov/paymentsystems/title-viii-dfa.htm.
[8] *See* Federal Reserve Policy on Payment System Risk, available at https://www.federalreserve.gov/paymentsystems/psr_about.htm.

- authorize a Federal Reserve Bank to establish and maintain an account to a designated FMU and to provide services available to eligible banks; and
- authorize a Federal Reserve Bank to pay interest on balances maintained by an FMU.

REGULATION HH AND FEDERAL RESERVE BANK ACCOUNT SERVICES

The Federal Reserve adopted Regulation HH to implement the provisions of Title VIII of the DFA.[9] Pursuant to Section 12 C.F.R. § 234.1, Regulation HH was issued under the authority of sections 805, 806 and 810 of the DFA; therefore, should Section 141 of H.R. 10 become law, Regulation HH would almost certainly be repealed by the Federal Reserve.

Regulation HH has four general sections. The first requires that a designated FMU implement rules, procedures or operations designed to ensure that it meets or exceeds listed risk-management standards with respect to its payment, clearing and settlement activities.[10] These standards are intended to be similar to, or exceed, the international "Principles for financial market infrastructures" ("PFMI") standards published in 2012 by the Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO").[11] The second section provides that a designated FMU must provide at least 60 days advance notice to the Federal Reserve of any material notice.[12] This requirement is in addition to any rule filing required by the FMU's primary federal regulator, and it permits the Federal Reserve to prevent any rule filing from becoming effective should the agency believe the rule would raise systemic risk issues.

The third section details that a Federal Reserve Bank may open an account for a designated FMU should such FMU maintain sufficient standards.[13] The services that may be offered are detailed in Federal Reserve Bank operating circulars, and include cash and credit services. Operating Circulars 2 (Cash Services) and 10 (Lending) are particularly critical for management of liquidity risks at FMUs.[14] The fourth section confirms that balances in accounts maintained by an FMU are eligible for interest payments.[15] The Powell Speech notes that all FMUs designated by FSOC have accounts at a Federal Reserve Bank. These accounts permit each FMU to hold cash and to avoid

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[9] *See* https://www.ecfr.gov/cgi-bin/text-idx?c=ecfr&sid=74d9708a8834717f77a422d23fff0ab6&rgn=div5&view=text&node=12:4.0.1.1.5&idno=12.
[10] 12 C.F.R. § 234.3(a).
[11] The 2012 CPSS-IOSCO report is available at http://www.bis.org/cpmi/publ/d101a.pdf.
[12] *Id*. at § 234.4.
[13] *Id*. at § 234.5.
[14] *See* https://www.frbservices.org/regulations/operating_circulars.html.
[15] *Id*. at § 234.6.

the circular risk that arises when an FMU deposits cash with a clearing member.[16] It also eliminates the risk from market disruptions in the repo market, or other operational or timing issues.[17]

Should H.R. 10 become law, all of the above regulatory provisions would be eliminated. Of these, perhaps the most dangerous is that FMUs would lose access to available emergency liquidity from the discount window and would be reliant on market- and member-funding in the next crisis. As both those sources are often themselves highly compromised in the heart of a crisis, the loss of Federal Reserve Bank liquidity could be critical to an FMU and materially systemically important. The issue of CCP liquidity has been heavily debated over the last few years, and is beyond the scope of this article, but we do note the effect of the repeal of Title VIII on this ongoing discussion.[18]

QCCPS AND BASEL 3

It is key to be a QCCP under Basel 3. If an FMU is a QCCP (or a "Q", as per industry jargon), members or participants that are banking entities subject to Basel 3 capital requirements may hold significantly less capital against CCP exposures than they would against non-Q CCP exposures. This Q – non Q distinction is a newly installed feature of Basel 3.[19]

A QCCP is defined as a CCP that (1)(i) **is designated as an FMU**; (ii) if not located in the U.S., is regulated and supervised in a manner equivalent to a designated FMU; or (iii) meets the following standards: (A) the CCP requires all parties to be fully collateralized on a daily basis; (B) the banking entity demonstrates to its primary regulator that the CCP (1) is in sound financial condition; (2) is subject to supervision by a primary federal regulator, or if not located in the U.S., is subject to effective oversight by a national supervisory authority in its home country; and (3) meets or exceeds risk-management standards for CCP set forth by its primary federal regulator, or if not located in the U.S. its home country supervisory, that are consistent with international standards established by the Bank of International Settlements; and (2)(i) provides the

[16] *See* Powell Speech ("[t]he ability to deposit cash at a central bank allows for another safe, flexible and potentially attractive option …").
[17] Pursuant to Title VIII (12 U.S.C. § 5465), the Federal Reserve may authorize a Federal Reserve Bank to permit an FMU to discount and borrow *only in unusual or exigent circumstances* upon the vote of a majority of the Governors of the Federal Reserve and after consultation with the Secretary of the Treasury, and upon a showing by the FMU that it is unable to secure adequate credit from banking institutions.
[18] The industry and regulators have been taking steps to address these liquidity issues. *See, e.g.,* the Fixed Income Clearing Corporation's proposed Capped Contingency Liquidity Facility for the Government Securities Division. SR-FICC-2017-002 (March 14, 2017); *see also* Powell Speech "[a]s a central bank, we are particularly concerned with liquidity issues [for FMUs]").
[19] *See* https://www.gpo.gov/fdsys/pkg/FR-2013-10-11/html/2013-21653.htm.

banking entity with the CCP's hypothetical capital requirement and other relevant information; (ii) makes available to its primary federal regulator and the CCP's regulator the information provided to the banking entity; and (iii) the CCP has not been determined to NOT be a QCCP due to financial condition, risk profile, risk-management standards, or other weaknesses or supervisory concerns.[20]

Therefore, for the eight FMUs currently designated as systemically important by FSOC under Title VIII of the DFA, they presently are automatically Qs due to the five words bolded and underlined in the paragraph above. Should Title VIII be repealed by Section 141 of H.R. 10, the eight CCPs would have to satisfy the other portion of Q test, which apparently has never been applied in the United States. Otherwise, every banking entity member or participant of these CCPs would immediately be hit with a huge capital hike on its trading, clearing and payments activities that would likely cause many of these banks to curtail their activities until this uncertainty was settled.[21] In effect, the repeal of automatic designation would shift the burden of determining Q status from the government (FSOC and the Federal Reserve) to each individual banking entity member of such CCP.

Finally, for those FMUs for which the Federal Reserve is the primary federal supervisor – the Clearing House Payments Company, L.L.C. (on the basis of its operation of the Clearing House Interbank Payments System) and CLS Bank International – the repeal of Title VIII and the deletion of Regulation HH would eliminate the risk-management standards promulgated by the Federal Reserve pursuant to Section 805(a)(1)(A) of the DFA and Section 234.3 of Regulation HH. Without confirmation of these standards, these two FMUs would not be considered by supervisors outside of the United States to be meeting or exceeding the PFMI standards adopted worldwide. The six other FMUs would need to consider the effect of the repeal of Title VIII with their own respective federal supervisory agencies.

CONCLUSION

We understand that financial market utilities were not on the top of any Congress person's mind when they were voting for H.R. 10. However, central banks, commentators and journalists have noted that one possible starting point for the next

[20] The definition of QCCP ends by noting that "(3) A QCCP that fails to meet the requirements of a QCCP in the future may still be treated as a QCCP under certain conditions." While directly relevant to a de-designation by FSOC, another provision in Basel 3 states that a banking entity may treat a CCP as a Q for up to three months following its loss of QCCP status. *Id* at Subpart A; Section 3(f).

[21] Section _ 35 "Cleared Transactions" lists the relative capital requirements for banking entity exposures to QCCPS and non-QCCPs.

financial crisis is, in fact, FMUs.[22] While FMUs work diligently to transfer, transmit, settle and clear risk from financial market participants, they also by their very nature are entities of significant risk accretion. Many regulators and market participants are aware of this issue and have worked diligently since the last financial crisis to mitigate it. H.R. 10 sloppily takes away from regulators and FMUs a few of the risk mitigation tools they currently have.

[22] *See, e.g., https://www.globalcustodian.com/John-Gubert/Will-CCPs-Be-the-Root-Cause-of-the-Next-Financial-Crisis-/; https://www.ft.com/content/b40fb70e-effa-11e4-bb88-00144feab7de?mhq5j=e3; https://www.bloomberg.com/news/articles/2016-10-05/eu-readies-plans-for-clearing-crisis-the-next-too-big-to-fail; https://www.federalreserve.gov/newsevents/speech/powell20141106a.htm.*

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