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Update: The Clearing Mandate in Dodd-Frank, Systemic Risk, and Competition

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Regulatory rule making is often poised on a knife-edge: insufficiently restrictive rules do not fully fulfill the intent of underlying legislation, while overly-restrictive rules spawn a host of unintended consequences. Implementation of the clearing mandate in Dodd-Frank (DF) is no exception:

- **Clearing unsuitable products, i.e., products with prices that are difficult to ascertain and risks that are difficult to assess, could endanger the viability of central counterparties (CCPs). Therefore, regulators will sensibly err on the side of caution and mandate clearing only for the very most liquid swaps. Ironically, this means that clearing itself will not do much to reduce systemic risk.**
- **Rules on CCP governance and procedures are intended both to limit systemic risks arising from the expanded role of the CCPs and to foster competition in swaps markets. As safeguarding the CCPs will again be the dominant motivation, regulators will not, as some have hoped, use clearing to level the competitive playing field at the expense of the dealers.**
- **Regulators will use margin requirements to limit systemic risk in markets for non-cleared swaps. This will be a significant challenge. Furthermore, setting margin too low will do little to mitigate systemic risk while setting margin too high will unleash unintended consequences that might very well increase systemic risk.**

Defining Products Subject to the Clearing Mandate

One would expect the starting point of a clearing mandate to be a definition of which products have to be cleared. But the DF mandate is unabashedly circular: “It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing ... if the swap is required to be cleared.”¹ The intent, of course, was for regulators to use the law’s enumerated list of factors to define which swaps have to be cleared. But, in the words of one comment letter,² DF “adopted a multi-factor test of enormous complexity and questionable utility.” Not surprisingly then, more than a year after the passage of the Over-the-Counter Derivatives Market Act of 2009, the precursor of Dodd-Frank, and almost a year after the passage of Dodd-Frank itself, no practical definitions have emerged. The Commodity Futures and Trading Commission (CFTC), for example, has proposed 10 rules with respect to the clearing mandate, but none provides details with respect to the central issue of which swaps have to be cleared.

The regulators are, in fact, in a very difficult position. Defining the clearing mandate too narrowly clearly fails to fulfill the law’s expectations. Defining the clearing mandate too broadly, however,

¹ Dodd-Frank, §723(a)(3).

² Comment for Proposed Rule 75 FR 67277 from Craig S. Donohue, CME Group, Inc.



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that is, mandating the clearing of products for which prices are difficult to obtain and risks difficult to assess, could either shut down the markets for these products—as counterparties and CCPs decide not to bear the costs and risks of clearing—or increase systemic risk by exposing CCPs to the risks of products unsuitable for clearing.

Reading the tea leaves of regulatory words and actions to date, the most likely outcome is that regulators will sensibly avoid doing harm. In particular, they will mandate clearing only for the most liquid and transparent products, i.e., interest rate swaps (IRS) and credit default swaps (CDS) on relatively liquid corporate names and indexes.

A possible harbinger of this regulatory outcome is the U.S. Treasury's recent proposal, its prerogative under DF, to exempt foreign exchange swaps and forwards from clearing and other requirements.³ In an almost incredibly timid approach, the Treasury concluded that “the challenges of implementing central clearing within this market significantly outweigh the marginal benefits that central clearing ... would provide,” going so far as to cite master netting agreements and credit support annexes, which are very common across derivatives markets, as a reason to exempt foreign exchange swaps and forwards.⁴

The irony of this forecast for the clearing mandate is that the most liquid derivatives markets, which are of least concern with respect to systemic risk,⁵ will be most affected. Furthermore, vanilla IRS and CDS are already cleared between dealers, meaning that any incremental reduction in systemic risk has to come about through the clearing of highly liquid product by non-dealers. But since these markets are the least subject to systemic risk in the first place, and since only a handful of non-dealers can conceivably be categorized as systemically important, the incremental reduction in systemic risk by mandated clearing will be quite limited.

Rules for the Governance and Procedures of CCPs

The combination of mandatory clearing and the economies of scale in clearing⁶ will result in a legal oligopoly of CCPs. Regulation of CCPs under DF, therefore, has two purposes: one, to ensure the viability of these systemically important institutions; two, to ensure that CCPs, whose members are almost exclusively dealers, do not abuse their market power.

Customers, a simplified category of non-dealer market participants, are legitimately concerned that their access to clearing, at reasonable cost, is subject to the whims of dealer-members. While customers do depend on dealers in OTC markets, and while this dependence exists in futures markets as well, the fact that clearing is mandatory heightens customer concerns about

³ See “Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act,” Department of the Treasury, April 29, 2011.

⁴ See “On the Clearing of Foreign Exchange Derivatives,” by Darrell Duffie, Graduate School of Business, Stanford University, May 12, 2011, for a discussion of the Treasury's analysis.

⁵ See “Amending Safe Harbors to Reduce Systemic Risk in OTC Derivatives Markets,” by Bruce Tuckman, CFS Policy Paper, April 22, 2010.

⁶ Clearing through one entity is simpler technologically and produces consolidated position reports. Also, so long as trades are not perfectly correlated, a portfolio has less counterparty risk when cleared through one CCP than when broken up and cleared through several CCPs of equal credit quality.



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access. Dealer-members, on the other hand, are legitimately concerned about their exposures to losses (above margin collected) incurred by the CCP as a result of defaults on cleared trades. Furthermore, dealers reasonably demand compensation for any risks and operational costs that they assume.

Again reading the regulatory tea leaves, it appears that clearing itself will not be used to level the playing field in the swaps market. If anything, the clearing mandate is likely to shift market power to the dealers. Three rule-making areas illustrate this point: CCP membership, intermediation, and margin.

In very early discussions about the clearing mandate, customers were hoping for relatively low hurdles to CCP membership. Consistent with these hopes is a proposed CFTC regulation that sets a maximum allowable capital requirement for clearing members at a level very much below the minimum set by existing, dealer-dominated CCPs. The most likely outcome, however, is that some large customers will become members, but that the dealer community will dominate the CCPs; as in the case of product coverage, the regulators will sensibly avoid doing harm and will not risk the viability of CCPs by forcing a significant expansion of membership.

Intermediation is the process by which a clearing member clears a trade—in which it did not take part—on behalf of a non-member. When clearing is mandatory, reliable and cost-effective intermediation is crucially important so that customers can trade with the counterparty that offers the best price rather than having to trade with only a few clearing members.⁷ Recognizing this, a proposed regulation prohibits a CCP from refusing to clear trades done by non-members. But dealer-members are not utilities that can be forced to provide intermediation services at terms customers find acceptable; competition between dealers, rather than regulation, will determine the terms of intermediation.

Counterparties post margin to guarantee future performance on trades. In OTC markets, the amount of margin for a trade or portfolio of trades is determined by competitive forces. With mandatory clearing, the dealer-dominated CCPs, with the approval of the relevant regulators, determine margin for all cleared swaps. Hence, through the CCPs, dealers can actually coordinate margin levels and need not compete along that dimension.

Margin Requirements for Non-Cleared Swaps

Relatively illiquid swaps are, as discussed above, not likely to be subject to mandatory clearing and are more likely to be the cause of systemic disruption. One means by which regulators hope to limit systemic risk in these markets is by margin requirements. According to proposed rules, margin has to be posted, with some end-user exceptions, and the methodology for calculating the amount of margin required has to be calculated in a manner approved, in one way or another, by regulators.

Regulators have taken on quite a task here. One important reason that certain swaps will not be cleared is that their risks, and, therefore, appropriate margin levels, are difficult to determine.

⁷ Customers do not want to clear through several different CCP members for the same reason that dealers do not want to clear through several CCPs. See the previous footnote.



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Hopes expressed in proposed rules, that models used by CCPs for cleared swaps will be applicable to non-cleared swaps, are not likely to be realized. Similarly, it will be far from trivial to implement regulatory plans to determine margin levels for non-cleared swaps by applying “multipliers” to margin levels for cleared swaps or by using “look-up tables” based on notional amounts.

The difficulties regulators will face in setting margin for non-cleared products means that the outcome is very much poised over the proverbial knife-edge. If margin is set to low, its imposition will do little to mitigate systemic risk. If, on the other hand, margin is set too high,⁸ market participants might reduce hedging activity; shift hedges to less customized products; hedge offshore; or hedge through instruments that are not as strictly regulated. All of these reactions, of course, could very well increase systemic risk.

Another part of DF intended to reduce systemic risk for non-cleared swaps, unrelated to margin, is the requirement to report trade details to a swap data repository (SDR) or directly to a regulator. It is unclear, however, how the accuracy of this data can be ensured, how such large quantities of raw position data can be usefully analyzed, and how these data can possibly be precise and timely enough to manage through a crisis. Hence, data in an SDR or at a regulator are more likely to be useful for forensic purposes than for the mitigation of systemic risk.

Conclusion

Rule making is hard and implementing the DF clearing mandate is no exception. The realities facing the regulators will very much limit how much regulators can reduce systemic risk and foster competition. Furthermore, for relatively illiquid products, which will ultimately not be cleared, systemic risk may increase or decrease according to how well regulators solve the difficult problem of determining appropriate margin levels.

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⁸ Included in the possibility of margin being set too high are requirements to segregate customer margin. Without this requirement, a dealer can use margin posted by a customer as margin to post on an offsetting trade. With this requirement, the dealer has to use additional capital for the offsetting trade.