Comment

Dodd-Frank's Swap Clearing Requirements and Systemic Risk

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Credit Default Swaps (CDS) have been widely criticized for exacerbating losses during the recent financial crisis. Accordingly, a reorganization of the CDS market is a primary goal of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act seeks to mitigate systemic risk by moving more trades onto central clearinghouses. In this Comment, I argue that the various provisions of the Dodd-Frank Act related to central clearing might actually undermine the law’s objectives.

I focus on the penal rules governing uncleared CDS. These regulations are meant to account for the supposedly greater risk of uncleared trades and to encourage the use of clearinghouses. In actuality, the bifurcated treatment of cleared versus uncleared CDS creates incentives for banks to clear as many types of CDS as possible, including instruments with features that render them unsuitable for central clearing.

As an alternative policy, I recommend that regulators require banks to move all CDS dealing activities to separately capitalized affiliates. Regulators should recognize that CDS, cleared or uncleared, generate significant systemic risk. By eliminating the implied government backstop, banks will internalize the full social costs of CDS trading. Insofar as clearinghouses effectively reduce counterparty risk for certain transactions, participants will be motivated to clear, rather than simply shifting activities to the trading venue with the most advantageous regulatory treatment.

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Introduction

The events of 2007-2008 exposed material weaknesses in the global financial system. Among the many contributing factors cited, the market for Credit Default Swaps (CDS) has been largely condemned for exacerbating losses, prompting government bailouts of major financial institutions. Reform of this market has accordingly become a primary regulatory objective in the aftermath of the crisis.

CDS fall into a category of financial instruments broadly known as “swaps.” A “swap” is a contractual agreement between two counterparties to exchange future payment streams based on the performance of some underlying market variable, such as interest rates, foreign exchange rates, and commodity prices. For CDS, the variable of interest is the credit risk of an underlying asset, e.g., a single corporate name, a basket or index of corporate credits, or a structured product such as a mortgage-backed security. Standard CDS contracts require the “protection buyer” to make periodic premium payments to the “protection seller,” who promises to make a payment to the protection buyer if the “reference entity” experiences a “credit event,” including bankruptcy, default, or restructuring.

CDS (and swaps more generally) are primarily traded on a bilateral basis. Counterparties deal directly with each other, exposing themselves to the risk that the other party might fail to honor its payment obligations, a possibility that became all too real during the financial crisis. In an alternative market with

1. FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT, at xxiv (2011) ("[CDS] amplified the losses from the collapse of the housing bubble . . . and helped spread them throughout the financial system."); see also Darrell Duffie, How Should We Regulate Derivatives Markets?, Briefing Paper No. 5, PEW FIN. REFORM PROJECT 1, 5-6 (2009), http://fic.wharton.upenn.edu/fic/policy%20page/Pew_Duffie_Derivatives_Paper_FINAL-TF Correction.pdf (noting that CDS led to failures or near-failures among insurers such as AIG and AMBAC and weakened the financial position of investment banks such as Lehman Brothers and Bear Stearns).


4. See Daniel Heller & Nicholas Vause, Expansion of Central Clearing, BIS Q. REV. 67, 68 (June 2011) (noting that over 90% of CDS trading is conducted bilaterally; for other types of swaps, the rate is lower but still significant, e.g., 50% of interest rate swaps are still traded bilaterally).
central clearing, a single main institution—the clearinghouse—stands between buyers and sellers and guarantees each party’s performance. Based on the premise that central clearing will reduce systemic risk, the Dodd-Frank Wall Street Reform and Consumer Protection Act proposes sweeping changes to the infrastructure of the overall swaps market.5 First, the Act authorizes the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to mandate central clearing for certain transactions.6 Second, the so-called “Swaps Push-Out Rule” effectively requires banks to spin off certain swap trading activities into separately capitalized affiliates.7 Specifically, and central to this essay’s argument, CDS trading cannot occur in government-insured bank entities unless the CDS are cleared.8 Finally, the Act empowers regulators to impose strict margin and capital requirements9 for uncleared swaps “[t]o offset the greater risk to . . . the financial system arising from the use of swaps that are not cleared.”10

In this Comment, I argue that the laws and regulations designed to promote clearing create incentives that might undermine the stability of clearinghouses. I focus on the CDS market and suggest that the penal treatment of uncleared CDS encourages expansion of clearing to instruments that clearinghouses cannot properly risk-manage. As an alternative strategy, I recommend that policymakers require banks to move all CDS dealing to separately capitalized affiliates. Only purchases of CDS related to bona-fide hedging transactions should remain in the insured bank entity. As far as

5. The Dodd-Frank Act defines “swap” broadly to include not only those instruments traditionally referred to as swaps, see supra notes 2-3 and accompanying text, but also other types of financial instruments not typically given this label, such as structured equity options. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] (to be codified in scattered sections of the U.S. Code). See § 721(a)(21) of the Act for a listing of the financial instruments covered by the term “swap.” Additionally, the Act makes a distinction between “swaps” and “security-based swaps.” See id. § 721(a)(19). This Comment will use the term “swap” to refer to both traditional “swaps” and “security-based swaps” as defined under the Act, unless specified otherwise.

6. Id. § 723(a)(3) (providing for the CFTC’s authority to mandate clearing of swaps); id. § 763(a) (providing for the SEC’s authority to mandate clearing of security-based swaps). The CFTC and SEC have yet to promulgate many of the rules implementing the Dodd-Frank Act. Accordingly, the analysis in this Comment is preliminary and based on proposed rulemakings, statements from officials, and general expectations of how these agencies will proceed.


8. Dodd-Frank Act § 716(d)(3).

9. Margin refers to collateral that a party to a financial transaction posts to cover some or all of the credit risk to their counterparty, the amount of which will typically increase or decrease to reflect the changing value of the transaction. See HULL, supra note 2, at 26 (describing the use of margin in futures contracts). Capital requirements refer to minimum levels, as set by regulators, of a bank’s assets that do not have to be repaid and therefore are available as a buffer in case of unexpected losses. See Douglas J. Elliott, Bank Capital and the Stress Tests, INITIATIVE ON BUS. & PUB. POL’Y AT BROOKINGS 8-9 (Mar. 3, 2009) (discussing bank capital).

10. Dodd-Frank Act § 731; see id. § 764(a).
clearinghouses reduce counterparty risk for CDS dealers, participants will be endogenously motivated to clear.

Part I of this Comment explains the differences between bilateral and central clearing. Part II discusses the Dodd-Frank Act's reforms of the swaps market and why the differentiated approach towards cleared versus uncleared CDS creates incentives for banks to push more trades onto clearinghouses. Part III explains why the urge to clear will increase the likelihood of clearinghouse failure. I conclude in Part IV by suggesting that all CDS dealing by banks be moved to separately capitalized affiliates.

I. Bilateral versus Central Clearing

The current structure of the swaps market presents concerns for systemic risk. Instead of a central marketplace, a network of dealers intermediate trades for end clients. Dealers trade bilaterally with one another, leaving them exposed to each other's credit risk.11 Accordingly, the failure of an entity with a sizeable swaps portfolio would negatively impact its trading counterparties. Losses could propagate through the market, ultimately culminating in a cascade of failures of financial institutions and disruption to the wider economy. Given the concentration of the swaps market, which has a limited number of major dealers,12 large exposures can accumulate quickly and create systemic risk.13

As noted earlier, of the various classes of swaps, commentators have singled out CDS as having played a significant role in the financial crisis.14 AIG's near collapse provides the clearest example of the potential dangers of a bilateral market. As of September 2008, AIG had sold $377 billion in credit protection through the CDS market, primarily on highly rated, mortgage-backed securities.15


12. As of 2010, the top fourteen swaps dealers accounted for 82% of the total notional amounts outstanding. David Mengle, Concentration of OTC Derivatives Among Major Dealers, 4 ISDA Research Notes (2010), http://www.isda.org/researchnotes/pdf/ConcentrationRN_4-10.pdf. Within the commercial banking sector, the concentration is even more stark: the top five U.S. commercial banks account for over 95% of all swap exposures among the nation's commercial banks. Office of the Comptroller of the Currency, OCC's Quarterly Report on Bank Trading and Derivatives Activities Second Quarter 2011.

13. See Kress, supra note 3, at 59.

14. See, e.g., Press Release, U.S. Securities and Exchange Commission, SEC Chairman Cox Statement on MOU with Federal Reserve, CFTC To Address Credit Default Swaps (Nov. 14, 2008) ("The virtually-unregulated over-the-counter market in credit default swaps has played a significant role in the credit crisis . . . ."); Karl S. Okamoto, After the Bailout: Regulating Systemic Moral Hazard, 57 UCLA L. Rev. 183, 196-203 (2009) (blaming failure of Bear Stearns, Lehman Brothers and AIG on CDS); René M. Stulz, Credit Default Swaps and the Credit Crisis, 24 J. Econ. Perspectives 1, 78 (2010) (discussing how credit default swaps may create excessive leverage in the system and promote excessive risk-taking). For a general discussion of the perceived causes of the financial crisis, see Fin. Crisis Inquiry Comm'n, supra note 1.

As the value of these supposedly safe securities plummeted, it became apparent that AIG would not be able to meet its expected payments to counterparties. Fearing that an AIG failure could initiate a chain-reaction of defaults that would ripple through the broader banking system, the Federal Reserve Bank of New York orchestrated an $85 billion bailout, which has since ballooned to $182 billion in government support.¹⁶

Central clearinghouses potentially mitigate the systemic consequences of a counterparty default. When parties transact, the contract is novated to the clearinghouse, which then stands in the middle of both sides of the trade. Hence, the clearinghouse becomes the “buyer to every seller and the seller to every buyer.”¹⁷ Advocates of clearing typically note two key benefits of central clearinghouses: (1) strict margining requirements and default resolution mechanisms and (2) reduction in notional exposures through multilateral netting.

Although margining is already prevalent in the CDS and the broader swaps market,¹⁸ central clearinghouses impose consistent and formal collateral requirements across all clearing members.¹⁹ Moreover, in the event of a clearinghouse member default, any losses in excess of posted collateral are covered through an initial contribution to a capital fund that the insolvent entity originally made as per the terms of clearinghouse membership. If uncovered losses remain, those outstanding amounts are discharged through an assessment of the capital funds of the other clearinghouse members. Losses are thereby mutualized across the clearing members, diffusing the impact of a counterparty failure relative to the bilateral context.²⁰

Clearing may also reduce risk through multilateral netting. Since the clearinghouse assumes the trading positions of all its members, it can offset all underlying trades against each other. That is, if a clearing member is long a trade against one dealer and short the identical position with another dealer, its net position from the perspective of the clearinghouse is zero. As a result, relative to the bilateral context where each party can only net trades facing each of its individual counterparties, clearinghouses can reduce the aggregate size of

¹⁶. Id. at 945-46.
¹⁸. Over 93% of all credit derivative transactions, and 71% of all swap transactions were subject to collateral arrangements in 2011. ISDA Market Survey, INT’L SWAP & DERIVATIVES ASS’N (2012), http://www2.isda.org/attachment/NDM5MQ==/ISDA%20Margin%20Survey%202012%20FORMATTED.pdf.
¹⁹. Julia Lees Allen, Note, Derivatives Clearinghouses and Systemic Risk: A Bankruptcy and Dodd-Frank Analysis, 64 STAN. L. REV. 1079, 1086; see also Darrell Duffie et al., Policy Perspectives on OTC Derivatives Market Infrastructure 4-9, FED. RESERVE BANK OF N.Y. (Staff Report No. 424, 2010) (discussing the margining process for central clearinghouses).
²⁰. Kress, supra note 3, at 63.
counterparty exposures.\textsuperscript{21} The effect of netting can be significant and could further mitigate the systemic implications of a counterparty default.\textsuperscript{22}

II. Proposals Under Dodd-Frank

A. Mandatory Clearing for “Standardized” Swap Contracts

Title VII of the Dodd-Frank Act establishes a new framework for regulatory and supervisory overview of the swaps market. The law empowers the CFTC and SEC to mandate clearing for certain contracts.\textsuperscript{23} The Act, however, does not identify in any detail which types of swaps should be mandated for clearing, and much of the current debate on the issue concerns the proper scope of clearing. The Treasury Department’s original legislative proposal supported mandatory clearing of “standardized” contracts,\textsuperscript{24} which has since been echoed by the G-20.\textsuperscript{25} Nowhere is the term “standardized” clearly defined. As discussed in Part III, infra, many types of swaps might be standardized insofar as they have consistent contract terms, but they might display other features and risk-profiles rendering them inappropriate for clearing.

B. Treatment of Uncleared CDS Creates Incentives To Clear

Although the products that will likely be subject to initial mandatory clearing rules, such as basic interest rate swaps and foreign exchange transactions,\textsuperscript{26} account for a predominant share of the overall swaps market,\textsuperscript{27}
they did not create significant problems during the financial crisis. The success of the Dodd-Frank Act in reducing systemic risk will hinge on the treatment of more complex instruments that are not obviously suitable for clearing. Unfortunately, current proposals conflate the benefits of clearing with an assumption that uncleared swaps are inherently riskier. This bifurcated regulatory treatment will motivate banks to lobby clearinghouses to accept additional products—specifically CDS variants—beyond the simple instruments regulators have initially mandated to be cleared, ultimately undermining clearinghouse stability.

Section 716 of the Dodd-Frank Act, referred to as the "Swaps Push-Out Rule," provides that "no Federal assistance may be provided to any swaps entity." A bank becomes a "swaps entity" when it engages as a "swaps dealer," generally meaning that it actively makes markets in swaps, i.e., it "regularly buys and sells swaps with counterparties as an ordinary course of business for [its] own account." "Federal assistance" includes insurance from the Federal Deposit Insurance Corporation (FDIC) and access to the Federal Reserve's discount window. As every commercial bank in the U.S. is obligated to have FDIC insurance, banks must either cease being a swaps dealer or spin off such activities into a separately capitalized affiliate.

There are several exceptions to the ban against housing swap activities within an FDIC-insured banking entity. The rule allows for swap activities involving "[h]edging and other similar risk mitigating activities directly related to the insured depository institution's activities." Additionally, the exceptions

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28. *See* Mark Jickling, Congr. Research Serv., R40173, Causes of the Financial Crisis (Apr. 9, 2010) ("The largest [swaps] markets—interest rate and currency swaps—appear to have held up fairly well."); *see also supra* notes 11-16 and accompanying text (discussing the role of more complicated CDS instruments, such as the CDS that AIG traded, in the financial crisis).

29. Ironically, academics and regulators have almost exclusively focused on the concern that banks would attempt to circumvent clearing requirements by putting bespoke terms in the contracts that would make them insufficiently fungible to be traded on a clearinghouse. See, e.g., Hearing Before the Sen. Comm. on Agric., Nutrition, & Forestry, 111th Cong. (June 4, 2009) (statement of Gary Gensler, Chairman, Commodities, Futures, Trading Comm'n) ("[W]e must ensure that dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing."); Willa E. Gibson, *Clearing and Trade Execution Requirements for OTC Derivatives Swaps Under The Frank-Dodd Wall Street Reform and Consumer Protection Act*, 38 Rutgers L. Rec. 227, 229 (2011) (questioning whether "the bifurcated regulatory system for . . . swap contracts [would] incentivize market participants to customize their contracts to avoid the . . . clearing requirements and the added transparency of exchange trading to which most cleared trades will be subject").

30. Dodd-Frank Act § 716(a).


32. Dodd-Frank Act § 716(b)(1).


34. Dodd-Frank Act § 716(d)(1).
to the push-out requirement include swaps involving permissible rates and reference assets such as interest rates, foreign exchange, and *cleared* CDS.  

Therefore, banks that wish to be swaps dealers will be forced to set up separately capitalized affiliates to actively make markets in uncleared CDS. The non-bank subsidiary, in turn, will incur higher funding costs, since it will likely carry a lower rating than the commercial bank entity and will lack access to the bank’s deposit base.

Moreover, under current proposals from prudential regulators, margin requirements for uncleared CDS will be several times that of cleared CDS. Such proposals assume that uncleared trades are inherently riskier than cleared trades. While it is true that the products most suitable for clearing (simple, liquid contracts) are indeed less risky than more complex and illiquid contracts, it is not necessarily true that the instruments that actually end up being cleared are safer. Similarly, capital requirements for uncleared CDS will also be penal relative to cleared transactions. Banking regulators note their intention to promulgate capital requirements in accordance with the Basel III framework. The Basel Committee’s recommendations regarding capital for swaps activities, in turn, reflect an unfavorable treatment of uncleared CDS to “create incentives for banks to increase their use of central counterparties.” The Committee proposes assigning a 2% risk-weight for trade exposures facing a central clearinghouse. Meanwhile, for bilateral exposures, the applicable risk-weight would be at least 20% if facing another bank or at least 100% if facing a corporate financial institution. Concern that banks would circumvent clearing requirements was a key reason for this penal regulatory treatment of

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35. See id. § 716(d)(2) (exempting swaps involving rates or reference assets permissible for investment by a national bank under the National Bank Act, 12 U.S.C. § 24(Seventh)); § 716(d)(3) (requiring that for CDS to be exempt under (d)(2) it must be cleared).


37. The Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Farm Credit Administration (FCA), and the Federal Housing Finance Agency (FHFA).


41. Id. Under current regulatory capital frameworks, banks are required to hold a certain percentage of capital (historically 8%) against their total risk-weighted assets. Risk-weights are meant to reflect the riskiness of the asset, ranging from 0% for sovereign debt to 1250% for the riskiest assets. For a general discussion of the use of risk-weights in regulating bank capital, see Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, BASEL COMMITTEE ON BANKING SUPERVISION (June 2011), http://www.bis.org/publ/bcbs189.pdf.

42. Capitalisation of Bank Exposures, supra note 40, at 6.
Swap Clearing

uncleared trades.\textsuperscript{43} However, regulators have apparently ignored the fact that the push-out rule, combined with artificially high margin and capital requirements, might lead banks to move as many trades as possible onto clearinghouses. As I explain in the next Part, certain trades, while theoretically clearable, will increase the risk of a major clearinghouse failure.

III. Causes of Clearinghouse Failure

A. Expansion of Clearing May Pose Risk-Management Challenges

As noted earlier, the common refrain among regulators and policymakers is to promote clearing of “standardized” CDS.\textsuperscript{44} Unfortunately, this modest proposal belies the difficult and nuanced question of what types of products are actually appropriate for clearing. Even CDS with straightforward and standardized terms can vary dramatically in terms of their appropriateness for clearing due to the difficulties they create in managing counterparty risk. Although the Dodd-Frank Act instructs the CFTC and SEC to consider issues such as market liquidity before promulgating a clearing requirement,\textsuperscript{45} regulators intend to give individual clearinghouses great deference as to what products they accept for clearing\textsuperscript{46} and will seemingly follow their lead in mandating the swaps to be cleared.\textsuperscript{47}

For instance, some contracts have a risk-profile that will expose the clearinghouse to financial jeopardy. A clearinghouse is at a greater risk of failure when the likelihood of member default is elevated precisely when members owe the clearinghouse substantial amounts on their positions.\textsuperscript{48} This phenomenon is referred to as wrong-way risk. For instance, CDS on debt of sovereign nations are fraught with wrong-way risk, which arguably creates

\textsuperscript{43} See, e.g., Timothy Geithner, U.S. Treasury Secretary, Address to the International Monetary Conference (Jun. 6, 2011), http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx ("Imposing appropriate margin requirements on uncleared swaps will also help create incentives for market participants to use centralized clearing and standardized contracts so that they do not needlessly externalize risks to the financial system by avoiding central clearing."); see also supra note 29 and accompanying text.

\textsuperscript{44} See supra text accompanying notes 23-25.

\textsuperscript{45} Dodd-Frank Act § 723(a)(3).

\textsuperscript{46} The CFTC, for instance, will presume that a clearinghouse is “eligible to accept for clearing any swap that is within a group, category, type, or class of swaps that the [clearinghouse] already clears,” which seems to provide clearinghouses a great deal of room to accept a broad swath of different contract types. Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44,473 (July 26, 2011).

\textsuperscript{47} See Hearing Before the Senate Banking Subcommittee on Securities, Insurance, and Investment, 111th Cong. (June 22, 2009) (statement of Gary Gensler, Chairman, Commodity Futures Trading Comm’n) ("There should be a presumption that if an instrument is accepted for clearing by a fully regulated clearing house, then it should be required to be cleared.").

\textsuperscript{48} Craig Pirrong, The Economics of Central Clearing: Theory and Practice, 1 ISDA DISCUSSION PAPER SERIES 37; see also Anne Duquerroy et al., Credit Default Swaps and Financial Stability: Risks and Regulatory Issues, BANQUE DE FRANCE, FIN. STABILITY REV. 84 (Sept. 2009) (discussing the challenges that CDS present clearinghouses in terms of adequate margining).
insurmountable challenges for proper margining and clearinghouse risk-management. Sovereign CDS are no more technically complex than a single-name corporate contract and generally are quite liquid. However, due to the systemic implications of a sovereign credit event, a sovereign credit event could conceivably exhaust the capital fund of the defaulting clearing member. As a result, the capital funds of the surviving clearing members would absorb the shortfall. The losses to the other dealers would occur at a time of high market volatility and uncertainty, when capital is most valuable. As such, loss mutualization could serve to add further stress to the market and jeopardize clearinghouse stability.

B. Organization of Clearinghouses Encourages Excessive Clearing

Although historically run as non-profit utilities, modern clearinghouses tend to be for-profit businesses. As such, there might be a “race to the bottom,” whereby clearinghouses compete for business by lowering risk-management standards. A clearinghouse could seek to attract a greater share of the clearing market by accepting inappropriate swaps for clearing, setting inadequate margin and collateral requirements, or pursuing a combination of these strategies. If member defaults put the clearinghouse at risk of failure,

49. See Mark Pengelly, Sovereign CDS: Cat or Canary, RISK MAGAZINE (Mar. 5, 2010), http://www.risk.net/risk-magazine/feature/1594851/cat-canary (discussing how a sovereign default would roil global financial markets, aggravating counterparty risk precisely when payment is due under the contract); Craig Pirrong, You Can’t Mutualize, Insure, or Diversify Systematic Risk, WALL ST. PIT (Aug. 3, 2011), http://wallstreetpit.com/80706-you-cant-mutualize-insure-or-diversify-systematic-risk (discussing how clearinghouses are ineffective at reducing systemic risk due to the inability to diversify across clearing members when they are all negatively impacted by the same event).


52. Pirrong, supra note 48, at 9-10.

53. The possible failure of a clearinghouse is not merely an academic conjecture—large clearinghouses trading less complex products have failed before. In the wake of the 1987 market crash, a Hong Kong futures exchange became insolvent. That territory’s central bank stepped in, providing a bailout to avoid the disruption in financial markets that would have ensued had the clearinghouse failed. See Jeremy Grant, Quick View: Bernanke Sounds an Alarm on Clearing, FIN. TIMES: FT TRADING ROOM (Apr. 6, 2011, 6:17 PM), http://www.ft.com/intl/cms/s/0/d05a384e-6066-11e0-9fcb-00144f2ab9a9.html#axzz1LvWicBR. Interventionist policies with respect to clearinghouses are also not entirely unheard of in the United States. On October 20, 1987, the Federal Reserve took actions on behalf of First Options of Chicago to enable its parent, Continental Illinois, to inject funds into the subsidiary. See Ben S. Bernanke, Clearing and Settlement During the Crash, 3 REV. FIN. STUD. 133, 148 (1990).


the Dodd-Frank Act provides the clearinghouses access to the Federal Reserve discount window. Rather than shoring up private credit lines ex ante, clearinghouses are assured that they can fall back on liquidity from the Federal Reserve.

Even if clearinghouses resist the moral hazard that a government backstop creates, the influence of banks may still lead to excessive clearing. Banks have substantial equity ownership and voting power in the major global clearinghouses. Policymakers have recognized the potential conflicts of interest that this ownership structure creates, and the SEC and CFTC have proposed caps on ownership and voting power. It is not clear, however, whether these caps will prevent banks from coercing clearinghouses. The Department of Justice contends that the individual ownership and control caps do not go far enough, as they do nothing to curb the aggregate influence of dealers over the clearinghouse. Moreover, given the fact that the top fourteen swaps dealers account for over 80% of the total notional amounts outstanding, it is hard to imagine that they will not be able to bend clearinghouses to their will.

IV. Policy Proposals

Given the incentives that banks and central clearinghouses have to clear as many CDS as possible, and the increased probability of a clearinghouse failure as a result, it seems quite unlikely that one of the primary goals of the Dodd-Frank Act—reducing systemic risk—will be fully achieved. There needs to be a reassessment of the regulatory framework to ensure that banks internalize the full cost of the risks they undertake.

56. See Kress, supra note 3, at 84-87.
57. Admittedly, it is hard to imagine a clearinghouse contracting with banks to clear the most complex instruments where the clearinghouse completely lacks the tools for proper risk management; however, on the margin it seems quite plausible that clearinghouses will be willing to clear some products that might present risk management difficulties for the sake of garnering additional business, since they have the benefit of an implied government guarantee.
59. See RENA S. MILLER, CONG. RESEARCH SERV., R41715, CONFLICTS OF INTEREST IN DERIVATIVES CLEARING 5-10 (2011) (noting that the original concern of policymakers, contrary to the arguments in this paper, was in part that banks pressure clearinghouses to reject products for clearing, thereby allowing the banks to circumvent the clearing mandate).
61. Mengle, supra note 12.
62. See Wallace C. Turbeville, The Murky Realm of (Derivatives) Clearing, NEW DEAL 2.0 (Aug 9, 2010) (discussing how the large banks that control the bulk of the derivatives market might seek to influence clearinghouses), http://www.newdeal20.org/2010/08/09/the-murky-realm-of-derivatives-clearing-16862. But see Mengle, supra note 12, at 3 (suggesting that data on the derivatives market "do not suggest high concentration" since no single dealer among the top 14 accounted had more than an 11% market share).
So long as financial institutions engaging in CDS dealing have an opportunity to keep trading activities within an insured bank-entity, which benefits from a cheaper cost of funds due to its deposit base and artificial subsidy of being "too big to fail," they will attempt just that. By doing so, they can be assured that if their trading activities jeopardize the solvency of the firm, there will be a government backstop. An alternative policy of pushing all CDS dealing to separately capitalized affiliates would be the best, and potentially only, means of eliminating the systemic risk of CDS trading. There would be no artificially cheaper trading venue that would permit banks to engage in regulatory arbitrage. Clearing would arise naturally where benefits such as multilateral netting outweigh the costs of risk-centralization and improper clearinghouse risk-management due to product complexity and wrong-way risk. Purchasing CDS protection for the limited purpose of hedging risks directly attributable to traditional banking activities should remain permissible. It is only the active buying and selling of CDS as a swaps dealer that should be insulated from the broader banking system due to such activities' implications for systemic risk.

63. Proponents of the Dodd-Frank Act argue that the Orderly Liquidation Authority (OLA) under Title II of the Act and its restrictions on the use of taxpayer funds in liquidating a financial institution ends "too big to fail" while critics argue that the Act merely serves to institutionalize the process of government bailouts. For a discussion of these arguments, see Does the Dodd-Frank Act End "Too Big to Fail?," Hearing Before the Subcomm. on Financial Insts. & Consumer Credit of the H. Comm. on Financial Services, 112th Cong. 37 (2011).

64. Dodd-Frank Act § 716(d)(1). Unlike the difficult distinction between proprietary trading and market-making that continues to confound regulators implementing the "Volcker Rule," Dodd-Frank Act § 619, the line-drawing in deciding whether a CDS trade is truly a hedge seems quite feasible. For a general discussion of the Volcker Rule and difficulties in its implementation, see Charles K. Whitehead, The Volcker Rule and Evolving Financial Markets, 1 HARV. BUS. L. REV 39, 47-53 (2011). For the purposes of the swaps push-out rule, only purchases of CDS should qualify for such exemptions. So long as the depository institution is simply buying credit protection, there is little concern for it being "too big to fail." The counterparty to such a transaction simply does not receive future premium payments. It would then be the regulators' responsibility to ensure that the CDS purchases relate directly to a particular position or business risk.
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