

STATEMENT OF

Robert S. Steigerwald
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on

*Clearing the Next Crisis: Resilience,
Recovery and Resolution of Derivatives Clearinghouses*

**BEFORE THE COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES**

June 27, 2017

Longworth House Office Building
Washington, D.C.

Chairman Conaway, Ranking Member Peterson, and Members of the Committee, I appreciate the opportunity to testify today concerning some important public policy issues relating to central counterparty clearing. Specifically, my testimony will explain why I support the provision of central bank account services and, if necessary, emergency liquidity support – not solvency support – to clearinghouses.

I will briefly discuss the role that central banks have traditionally played both as depositories and liquidity providers and make some observations regarding “time-critical” liquidity in the modern financial system. Since I believe that clearinghouses are uniquely dependent on the immediate availability of liquidity in situations where private sector resources may prove to be inadequate, I believe that it is crucial for central banks to be prepared to provide emergency liquidity assistance in such circumstances.

Central Bank Account Services and Lender of Last Resort Function

Central banks have long played a critical role in the financial system as depositories and payment intermediaries.² Green and Todd (2001), for example, note that central banks historically were chartered to perform two primary functions:

¹ The views expressed in this statement are solely those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Chicago, the Board of Governors of the Federal Reserve System or any other person. This statement draws in significant part upon previous work with Robert T. Cox, Christian A. Johnson, and David A. Marshall. The author is solely responsible for the current form of the statement and any errors that may be present therein.

² See, e.g., Johnson & Steigerwald (2008); Millard & Saporta (2005); Green & Todd (2001); McAndrews & Roberds (1999)(examining the important role banks have historically played as payments intermediaries).

One is to be an intermediary between the government and its lenders, enabling the government to obtain credit by ensuring that implicit default through inflation will occur only in genuine national emergencies. The other is to serve broad public interests as the *trustworthy and neutral apex of a hierarchy of banks that, in turn, provide the nonbank public with accounts used to settle financial, business, and personal payments by transfer of balances*. [Green & Todd (2001), p. 5 (emphasis added)]

They conclude that “[t]he *role as the apex of the banking hierarchy* puts the central bank in a unique and distinguished position in the payments business.” [Green & Todd (2001), p. 5 (emphasis added)] Reflecting that special position, central banks today play a prominent role in large-value payment systems – including the provision of accounts and related services necessary for those systems to function properly.

Central banks also play a critical role in the modern financial system as providers of liquidity to the banking system. In particular, central banks today commonly play the role of “lender of last resort.” This function involves the provision of emergency liquidity assistance necessary to *solvent*, but *illiquid*, institutions that might fail without immediate central bank assistance.³

The Development of “Time-Critical” Liquidity Dependence

These functions are not new – but the environment in which central banks provide both account services and emergency liquidity assistance has changed profoundly over the past several decades. As Marshall & Steigerwald (2013) note, “modern financial markets are critically dependent on large-scale flows of intraday (within one day) liquidity in payment, clearing, and settlement systems.” They call this phenomenon “time-critical” liquidity:

[T]he processes for settling financial contracts, and related settlement-risk-management operations, increasingly make use of *time-critical liquidity* to address the problem of counterparty credit risk. Under conditions of time-critical liquidity, a settlement payment, delivery of securities, or transfer of collateral must be made *at a particular location, in a particular currency (or securities issue), and in a precise time frame* measured not in days, but in hours or even minutes. [Marshall & Steigerwald (2013), p. 30]

The authors conclude that this phenomenon is the cumulative result of public and private sector efforts to mitigate credit risk in financial markets over the past several decades, including;

³ There is an extensive literature on the lender of last resort function, which we do not attempt to summarize herein. See, e.g., Freixas, Parigi & Rochet (2003); Freixas, Giannini, Hoggarth and Soussa (2000); Oganesyanyan (2013).

- the proliferation of real-time gross settlement (RTGS) (such as Fedwire,[®] which is operated by the Federal Reserve Banks);
- the implementation of delivery-versus-payment (DvP) systems for securities and analogous payment-versus-payment (PvP) systems for foreign exchange to mitigate settlement risks; and
- the increasing use of collateral to mitigate counterparty credit risk in its various forms, both in payment systems and financial market clearing arrangements, such as central counterparties. [Marshall & Steigerwald (2013), p. 31]

Central counterparty clearinghouses are particularly vulnerable to liquidity risk in connection with the daily (and sometimes intraday) process of receiving and making mark-to-market settlements (or variation margin) with clearing members on a timely basis. [Peirce (2016), p. 622] These settlements are necessary in order to mitigate credit risk and are essential to the operation of a CCP. Peirce (2016) notes, for example, that “CCPs function by making and receiving payments according to a strict timeline” and that, above all else, “[a]dherence to a strict timeline of payments is important to keep the system working.” In addition, “during a crisis, CCPs likely would face significant liquidity strains” in connection with the daily exchange of variation settlements. [Peirce (2016), p. 622] While these strains maybe severe under such conditions, there is no reason why they must lead to disaster.

Support for Liquidity, Not Solvency

The liquidity stresses that a CCP may experience in connection with the time-critical exchange of settlement payments do not necessarily imply that the CCP is insolvent or likely to become insolvent. CCPs, unlike banks, have extraordinary default management and recovery powers to manage the consequences of a member default. [Cox & Steigerwald (2017), p. 13] The solvency of a CCP is not automatically called into question as a result of its default management and recovery efforts.

However, the CCP’s private sector liquidity arrangements may become unreliable as a result of severe market stress precisely when the immediate provision of immediate liquidity is essential. Accordingly, Marshall & Steigerwald (2013) conclude that “[i]f private liquidity provision may be inadequate in certain extreme conditions, it may be useful to create a framework in which central bank liquidity can act as a backstop.” [p. 32].

If the financial resources that clearinghouses depend on for default management and recovery purposes are held at the central bank, as I believe should be allowed, those resources will be immediately available when needed, without impairment as a result of the crisis. This, in turn, may facilitate the provision of emergency liquidity support by the central bank.

Conclusion

This is only a brief description of the consequences of time critical liquidity for the financial system. Nevertheless, for the reasons suggested herein, I believe that the provision of central bank account services and emergency liquidity support – not solvency support – to financial market infrastructures such as CCPs is warranted.

REFERENCES

Cox, Robert T., & Robert S. Steigerwald, 2017, "A CCP Is a CCP Is a CCP," Federal Reserve Bank of Chicago Working Paper, Vol. PDP, No. 2017-01 (April), available at: <https://www.chicagofed.org/~media/publications/policy-discussion-papers/2017/pdp-2017-01-pdf.pdf>

Freixas, Xavier, Curzio Giannini, Glen Hoggarth, & Farouk Soussa, 2000, "Lender of Last Resort: What Have We Learned Since Bagehot?," *Journal of Financial Services Research*, Vol. 18, No. 1, pp. 63-84, available at: http://download.springer.com/static/pdf/45/art%253A10.1023%252FA%253A1026527607455.pdf?auth66=1414692400_456528ae79e2853af58f2969790553e2&ext=.pdf

Freixas, Xavier, Bruno M. Parigi, & Jean-Charles Rochet, 2003, "The Lender of Last Resort: A 21st Century Approach," European Central Bank, Working Paper No. 298 (December), available at: <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp298.pdf>

Green, Edward J., & Richard M. Todd, 2001, "Thoughts on the Fed's Role in the Payments System," Federal Reserve Bank of Minneapolis, *Quarterly Review*, Vol. 25, No. 1 (Winter), available at:⁴ <https://www.minneapolisfed.org/research/qr/qr2512.pdf>

Johnson, Christian A., & Robert S. Steigerwald, 2008, "The Central Bank's Role in the Payment System," in International Monetary Fund, *Current Developments in Monetary and Financial Law*, Vol. 5 (Washington, D.C.: IMF)

Marshall, David A., & Robert S. Steigerwald, 2013, "The Role of Time-Critical Liquidity in Financial Markets," Federal Reserve Bank of Chicago, *Economic Perspectives*, Vol. 37 (2nd Qtr.), available at: <https://www.chicagofed.org/~media/publications/economic-perspectives/2013/2q2013-part1-marshall-steigerwald-pdf.pdf>

McAndrews, James, & William Roberds, 1999, "Payment Intermediation and the Origins of Banking," Federal Reserve Bank of New York, Staff Report No. 95 (September), available online at: <http://ssrn.com/abstract=935335>

Millard, Stephen, & Victoria Saporta, 2005, "Central banks and payment systems: Past, present and future," Background Paper, Bank of England Conference on "The Future of Payments," London (May), available online at: www.bankofengland.co.uk/financialstability/futureofpayments/background.pdf

⁴ This article originally appeared as an essay in the Federal Reserve Bank of Minneapolis 2000 Annual Report issue of *The Region* (April 2001, vol. 15, no. 1, pp. 5–27), available at: <https://minneapolisfed.org/publications/the-region/thoughts-on-the-feds-role-in-the-payments-system>

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http://www.ipe-berlin.org/fileadmin/downloads/working_paper/ipe_working_paper_19.pdf

Peirce, Hester, 2016, "Derivatives Clearinghouses: Clearing the Way to Failure," *Cleveland State Law Review*, Vol. 64, pp. 589 et seq., available at:

<http://engagedscholarship.csuohio.edu/clevstlrev/vol64/iss3/8>

BIOGRAPHICAL STATEMENT

Robert Steigerwald is a Senior Policy Advisor in the Financial Markets Group at the Federal Reserve Bank of Chicago.

Steigerwald began his legal career with Kirkland & Ellis, an international law firm based in Chicago, where he represented clients including the Board of Trade of the City of Chicago. He later served as legal counsel for a clearinghouse for foreign currency transactions and was instrumental in developing CLS Bank, a global multicurrency settlement system for FX transactions.

He joined the Federal Reserve Bank of Chicago in 2000 and is a member of the U.S. Commodity Futures Trading Commission's Market Risk Advisory Committee. He also has represented the Chicago Fed in the OTC Derivatives Regulators' Forum, an international forum for information sharing and regulatory cooperation among central banks, prudential supervisors and securities and markets regulators.

CURRICULUM VITAE

2000 —	FEDERAL RESERVE BANK OF CHICAGO <i>Senior Policy Advisor, Financial Markets Group, Economic Research Department</i>	Chicago, IL
1997-99	CLS SERVICES LTD. (CLS BANK INTERNATIONAL) <i>U.S. Legal Counsel</i>	London, U.K.
1996-99	MULTINET INTERNATIONAL BANK <i>Legal Counsel, Compliance Officer and Secretary</i>	New York, NY
1993-96	THE OPTIONS CLEARING CORPORATION and INTERNATIONAL CLEARING SYSTEMS, INC. <i>Legal Counsel and Corporate Secretary</i>	Chicago, IL
1992-93	KEMPER SECURITIES, INC. <i>Senior Attorney</i>	Chicago, IL
1985-92	KIRKLAND & ELLIS LLP <i>Attorney</i>	Chicago, IL
1980-82	SHEARSON-AMERICAN EXPRESS, INC. <i>International Trading Associate – Metals and FX</i>	New York, NY

Education

University of San Francisco School of Law, J.D., <i>cum laude</i>	1985
Stony Brook University, State University of New York, B.A.	1979

Selected Publications

“**Central Counterparty Clearing and Systemic Risk Regulation,**” in A. Malliaris and W. Ziemba (eds.), *The World Scientific Handbook of Futures Markets* (Vol. 5, 2015)

“The Role of Time-Critical Liquidity in Financial Markets,” Federal Reserve Bank of Chicago, *Economic Perspectives*, Vol. 37 (2nd Qtr. 2013), with D. Marshall

“What is clearing and why is it important?” Federal Reserve Bank of Chicago, *Chicago Fed Letter*, No. 278 (September 2010), with E. Nosal

“Derivatives Clearing and Settlement: A Comparison of Central Counterparties and Alternative Structures,” Federal Reserve Bank of Chicago, *Economic Perspectives*, Vol. 30 (4th Qtr. 2006), with R. Bliss

“Policymakers, Researchers, and Practitioners Discuss the Role of Central Counterparties,” Federal Reserve Bank of Chicago, *Economic Perspectives*, Vol. 30 (4th Qtr. 2006), with D. Evanoff and D. Russo

Selected Events, Presentations and Related Activities

U.S./Canada

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| 2010-15 | Annual FRB Chicago Symposium on Central Clearing – co-organize invitation-only symposium on central counterparty clearing and related issues, with D. Duffie and E. Nosal. | Chicago, IL |
| 2014-15 | Annual FRB Chicago Law & Finance Workshop – co-organize invitation-only roundtable discussion of selected topics, including: liquidity, collateralization, recovery and resolution and cross-border regulatory coordination, with C. Baker, C. Kahn, V. France. | Chicago, IL |
| 2014 | National Summit on Reform and Regulation of Derivative Transactions – panel discussion of “ <i>Execution and Clearing of Swaps: What the Market Model Will Look Like Going Forward and a Look at Uncleared Swaps.</i> ” | Washington, DC |
| 2011 | Global Association of CCPs (CCP12), Special Meeting – presentation on “ <i>CPSS-IOSCO FMI Principles: ‘Cover 1’ vs. ‘Cover 2’ – What Does the Historical Record Tell Us?</i> ” | Toronto, Canada |
| 2007 | Loyola U. Chicago, Center for Integrated Risk Management and Corporate Governance, Conference on Integrated Risk Management and Corporate Governance – presentation on “ <i>Enterprise-Wide Risk Management and Corporate Governance.</i> ” | Chicago, IL |
| 2004 | U. of Chicago Booth School of Business, George J. Stigler Center, Conference on Five Years of the Euro: Successes and New Challenges – co-organize conference on European monetary union and related issues, with R. Kroszner, E. Green. | Chicago, IL |

Europe

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| 2006 | FRB Chicago/European Central Bank, Conference on Issues Related to Central Counterparty Clearing – co-organize conference on central counterparty clearing, with D. Evanoff, D. Russo. | Frankfurt, Germany |
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Asia/Pacific

- 2013 **Bank of America Merrill Lynch Asia Central Bank and Sovereign Wealth Conference** – keynote speech on “2013 — The Year of Regulation, Basel III and Dodd-Frank;” panel discussion of “Regulatory Deep Dive: Implications of Basel III and Dodd-Frank.” Shanghai, PRC
- 2012 **Bank of Japan, FIA Japan, Keio University and Association of Central Counterparties (CCP12)** – presentations on “Central Clearing, Systemic Risk and Bankruptcy Issues.” Tokyo, Japan

Significant Litigation Experience

Board of Trade of the City of Chicago, et al. v. Board of Governors of the Federal Reserve System (U.S.C.A., 7th Circuit) and **Board of Trade of the City of Chicago, et al. v. Securities and Exchange Commission** (U.S.C.A., 7th Circuit)

- Represented Chicago Board of Trade in actions seeking review of Federal Reserve order permitting bank holding company to establish an OTC marketplace for securities options.

Ferruzzi Finanziaria, S.P.A., et al. v. Board of Trade of the City of Chicago (U.S. District Court, N.D. Illinois)

- Represented Chicago Board of Trade in litigation arising out of the July 1989 "Soybean Emergency."

Spicer, et al. v. Chicago Board Options Exchange, Inc., et al. (U.S. District Court, N.D. Illinois)

- Represented Chicago Board Options Exchange market makers in consolidated federal class action arising from the October 1987 market crash.
- Obtained dismissal of all claims against market makers, affirmed on appeal.

Stewart, et al. v. GNP Commodities, Inc., et al. (U.S. District Court, N.D. Illinois)

- Represented National Futures Association in first class action under Commodity Exchange Act alleging failure on part of self-regulatory organization to properly supervise a member.

Professional Activities and Distinctions

- **Bank of Japan** – Visiting Scholar, Institute for Monetary and Economic Studies (2005)
- **Chicago-Kent College of Law** – Adjunct Professor, Graduate Program in Financial Services Law (1993 to 2000)
- **American Bar Association** – Part 190 Joint Subcommittee (2015)
- **Federal Reserve Bank of Chicago** – President’s Award for Excellence (2008)

APPENDIX

[Marshall & Steigerwald (2013)]