Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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In the fog in which FSOC chooses to nestle, it was easy to miss an important indication briefly mentioned in the meeting's readout: the Council is "reviewing" current financial-market utility (FMU) designations. Firm-specific and activity-and-practice designations usually get all the airtime. So it was again on Friday, when FSOC also decided to back off its plan just last November (see *Client Report* **FSOC29**) to designate nonbank mortgage banking. The Council in fact mostly backs off much of what it promises – no wonder Rohit Chopra calls it a "book-report club." Precedent thus suggests the FMU threat is idle, but I'll bet it's not.

Why? The FMUs the Council is reviewing were made in 2012 very shortly after Dodd-Frank was enacted in 2010 and told it to do so. FMUs are to supplement firm designation because one clear lesson of the 2008 crisis is that market infrastructure matters at least as much as very big banks and a nonbank or two. FMU designations are thus designed to ensure proper functioning of the " clearing and settlement of payment, securities, and other financial transactions" (see FSM Report **PAYMENT11**). Designated payment companies are subject to Federal Reserve systemic supervision and securities and derivatives entities fall under either the SEC or CFTC. Unlike the Council's extremely-controversial designation at about the same time of four systemically-important financial institutions, the FMU designations then and ever since have drawn little scrutiny and no political dispute. Indeed, when Donald Trump's Treasury led a 2019 rewrite of the Obama era's designation process (see FSM Report **SIFI32**), it went out of its way to say that FMU designations were unchanged in any and all ways.

FSOC is not just right, but also overdue reconsidering the entities that now hold the payment, settlement, and clearing of trillions of financial transactions in fewer and fewer hands farther and farther outside the scope of operational-resilience, liquidity, and other essential systemic safeguards. Since the 2012 designations, the firms dominating these vital functions have changed radically. Think for example what a small role tech-platforms played in the payment arena over a decade ago, how Citadel had yet fully to earn its name, the nascent role of shadow banking, and how much critical infrastructure resided within the biggest banks forced under far tougher rules elsewhere in the Dodd-Frank Act.

One example detailed in a 2023 FedFin paper shows clearly just how much market-critical infrastructure has moved outside the reach of either current FMUs or the biggest banks under the toughest rules. The 2023 paper assesses the systemic implications of ICE's then-proposed takeover of Black Knight, an acquisition that gave it a controlling interest in the infrastructure vital for residential-mortgage payments, settlement, and servicing. In 2012, banks were a massive part of the residential-mortgage market, devoting the resources necessary to handle origination complexities, servicing challenges, and key decisions such as pricing all by themselves. With many banks able to originate, service, and process mortgages, the super-systemic mortgage market had

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operational redundancy, ample liquidity, and effective competition in critical areas other than the securitization controlled by Fannie and Freddie – classic examples if ever there were any of the risks of market infrastructure outside the reach of effective prudential and resolution rules. Now, as the new FSOC study of nonbank mortgage companies shows, banks have largely exited this sector and nonbanks lack the infrastructure essential for price competition and systemic resilience, one reason ICE was so big in the business even before it bought Black Knight.

ICE's role in the overall financial market makes mortgage-infrastructure dominance a still more systemic challenge. ICE is already so systemic in one part of the U.S. financial market – credit default swaps – that it's an FMU in this corner of its enterprise. It is also considered systemic for these purposes in the U.K. even as it now owns the New York Stock Exchange, controls commodities trading around the world, and has infrastructure-essential hands in many other sectors of the global capital market. No wonder ICE touted its Black-Knight acquisition not only on the grounds of how much power it would give the company in mortgage processing, but also because of its ability to link mortgages to new futures and secondary markets it said it could build to rival Fannie Mae, Freddie Mac, and even Ginnie Mae.

Who else is in FMU's sights? This FSOC may have limited time to get its thinking straight and initiate new designations, but it's clearly hard at work. Where the FMU pieces land is a strategic decision with far-reaching implications not only for systemic stability, but also for reinstating fair competition between the burdened regulatory-haves and the happy class of high-impact regulatory have-nots gaining a larger and larger role not just because they're good at what they do, but also because it's a lot more profitable to do it without a lot of rules.