



CCP risk is a borderless question in need of a global answer

Since the financial crisis of 2007 to 2008, regulators have accorded CCPs a leading role in the strengthening and re-regulation of financial markets. However, their expansion into new classes of asset and market participant has sparked a simultaneous debate on the concentration of risks at CCPs and their members, and their ability to mitigate and contain those risks. Natasha de Terán, head of corporate affairs at SWIFT, says unanswered questions demand a co-ordinated response from international policymakers.

In September 2014 J.P. Morgan Chase & Co. published a paper. Its title, *What is the Resolution Plan for CCPs?*¹ posed an obviously rhetorical question. There is no single resolution plan for central counterparty clearing houses (CCPs), and there cannot be one, but the paper did set out precisely what component J.P. Morgan Chase & Co. thought a successful plan would incorporate.

First, the bank made clear that it preferred preventative measures. In other words, J.P. Morgan Chase & Co. argued that

CCPs should plan carefully enough and husband sufficient resources to avoid a situation in which recovery and resolution would even need to be considered. Secondly, the paper considered recovery provisions as the priority. Only then did it go on to consider how a failed CCP should be resolved.

In CCP risk management, prevention is better than cure

Although the prescription of J.P. Morgan Chase & Co. was not welcomed in *all* quarters, the idea that recovery is superior to resolution appears eminently sensible.

¹ What is the Resolution Plan for CCPs?, September 2014, J.P. Morgan Chase & Co.



Measures which protect CCPs from getting into difficulty help to ensure that disaster never occurs. As Gary Cohn, president and chief operating officer of Goldman Sachs, put it in an article published in June this year,² both market participants and regulators should “maintain their focus on ensuring that the failure of clearing houses never becomes a real possibility.”

It is not only banks which have emphasized that it is better to prevent a CCP failing than to rescue one which has failed. Most of the work of the regulators on this issue has also focused on the protection of CCPs, rather than their resolution. Regulators have prescribed rules for CCP investment profiles; holding periods; margin parameters; risk assumptions; waterfall structures; and governance arrangements.

Many jurisdictions have implemented local requirements that put preventative measures of this kind into effect. The old adage – *an ounce of prevention is worth a pound of cure* – may hold true for CCPs. But *in extremis* those preventative measures will only ever go so far. The systemic importance

of CCPs, and the growing reliance of financial market participants on their intermediation, demand certainty in a crisis, if not a guarantee of continuity.

This consideration requires regulators to draw up and publish detail resolution plans for CCPs, and make compliance with them mandatory. But when will they do so, and how?

Concentration risk is not just a CCP problem

The matter is increasingly urgent. Since 2008, the role of CCPs has expanded dramatically. Today, they are intermediating more risks for more end-clients than ever before. Prior to the crisis, the clearing of over-the-counter (OTC) derivatives was a niche service, used by a select few in large but self-contained markets. Seven years on, market participants can clear almost every variety of OTC derivative, from index and single name credit default swaps, through cash-settled and non-deliverable forwards, to overnight index, inflation and variable notional swaps.

This is concentrating risk at CCPs. But, even if only a handful of major CCPs clear these products, it is not the CCPs alone

that are concentrating the risks – so too are their clearing members. The number of CCP members either self-clearing or clearing on behalf of third parties is not rising in line with the number of risks being cleared. Far from it, in fact - the number is actually shrinking.

Many of the brokerage firms that entered, or pondered entering, the clearing market as the drive to central clearing began in earnest in 2009, have since either exited the business, or abandoned their plans to become clearing brokers. Indeed, when Tabb Group studied the OTC clearing services landscape in June 2014, its analysts found that just 13 Futures Commission Merchants (FCMs) accounted for 50.5 percent of the global OTC derivative clearing market. The regular reports of the Commodity Futures Trading Commission (CFTC) show that the 174 FCMs active in the United States derivatives markets in 2002 had shrunk to just 75 by the end of 2014. Of those, only a fraction are clearing for third parties, and even fewer doing OTC derivative clearing.

From a contagion risk perspective, this concentration of business with a shrinking number of clearing brokers is more worrying than the concentration of risks at the CCPs. Should a clearing

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- Gary Cohn, Goldman Sachs

² Clearing houses reduce risk, they do not eliminate it, Gary Cohn, Financial Times 22 June 2015.



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- **Natasha de Terán, SWIFT**

member default at one CCP, the chance of it defaulting at a second is high. If a clearing broker defaulted at more than one CCP, the solvent clearing brokers could face calls from multiple CCPs to cover the shortfalls. Those calls would occur at precisely the time the positions of the failed clearing broker needed to be allocated to the solvent firms, when volatility would be rising in line with increased margin calls and growing credit concerns.

The resolution of the Lehman default left unanswered questions

That said, and as CCPs often point out, the Lehman Brothers default provides some reassurance that the difficulties can be surmounted. The investment bank was a major clearing member at all the leading CCPs, and carried both house and client positions. It was a major default, yet none of the CCPs sustained serious losses, all the house and client positions were either taken over or liquidated, and the margin held by the CCPs was sufficient to cover the costs.

But much has changed since the collapse of Lehman Brothers. Despite strong CCP

performance on that occasion, it would be imprudent to assume it guarantees similar success in the future. Moreover, even though the CCPs concerned can rightly congratulate themselves on their performance in 2008, the episode did raise four awkward issues that have yet to be resolved satisfactorily. First, co-ordination between the CCPs was far from perfect. Secondly, co-ordination between private sector entities and public sector authorities was not always harmonious. Thirdly, public sector co-ordination across borders was rudimentary. Finally, the resolution of the cleared Lehman positions raised questions about public and private money which are still unanswered.

The money question is easily the most urgent. It has two facets. The first is whether the public authorities should afford central bank liquidity to one, some or all CCPs that get into difficulty. The second is where CCPs are best advised to deposit surplus liquidity in a crisis.

Those who believe the re-regulation of financial markets aims primarily to avert public bail-outs of private problems naturally insist on the primacy of the first facet of the question. But the

second is equally important. Judging by the Lehman experience, CCPs can find themselves awash with liquidity at times of stress. This is because market volatility increases margin calls, and in times of stress clearing members will often prefer to post additional margin in cash rather than securities, including the substitution of cash for non-cash collateral they have posted already. The result is an accumulation of cash at CCPs. The CCPs obviously need to reinvest that cash quickly and safely, but it is not obvious where. By and large, they reinvest it either in the assets they clear, or with the clearing members for which they clear. The circular nature of these movements of cash is not reassuring.

International co-operation is easy in theory, hard in practice

The other three questions left unanswered by the handling of the Lehman collapse really reduce to a single question: Who decides? Any successful resolution of an ailing CCP will require decisive action by at least one authority. Where the activities of a CCP span borders, it will require close co-operation between the home authority and each of the authorities in



all of the jurisdictions in which the CCP provides clearing services.

The Financial Stability Board (FSB) is aware of this need. Its guidance expects the home authority of any cross-border CCP that gets into trouble to co-ordinate its actions with all other relevant regulators, central banks and public authorities. In a paper on CCP recovery and resolution published in December 2014, LCH.Clearnet echoed that advice.³

While it sounds sensible, the international co-ordination of multiple parties is not easy to deliver, especially for a large organization clearing a wide range of assets on behalf of a large number of clients and clearing members in a variety of jurisdictions around the world. If the solvency of large banks in any country, or the liquidity of its currency, swap or repo market, came to depend on CCPs and their supervisors in a third jurisdiction, it is a given that the government of the country affected would want to be involved in the decision made by the third country CCPs and supervisors.

This political reality argues strongly for a single global resolution framework for CCPs. Unfortunately, there is not even a single global recognition framework for CCPs in place today, nor an outline agreement between the relevant jurisdictions on the application of their respective insolvency regimes, let alone a single global resolution framework.

Finding a solution to this conundrum is becoming urgent. If a global consensus cannot be reached soon on the question of CCP recovery and resolution, it is only a matter of time before fragmentation sets in and the idea of a class of genuinely global CCPs will die.

Understandably, LCH.Clearnet is more concerned about this issue than its competitors. It clears interest rate swaps in Sterling, and in Hong Kong, Singapore, Australian and New Zealand dollars, as well as Japanese Yen. Its clearing membership is equally global. Its paper argues that work should begin to establish the enforceability of cross-border resolution regimes. It recommends that the international crisis management groups envisaged by the FSB should undertake regular crisis management exercises. Worryingly, the groups have yet to be formed, let alone started testing the viability of their plans.

³ CCP Risk Management, Recovery & Resolution, LCH.Clearnet White Paper, December 2014.



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