

First Joint Deutsche Bundesbank - European Central Bank - Federal Reserve Bank of Chicago Conference on CCP Risk Management

Summary of proceedings

Introduction

On **27 February 2019**, the European Central Bank (ECB) played host to the first “Joint Deutsche Bundesbank - European Central Bank - Federal Reserve Bank of Chicago Conference on CCP Risk Management” in Frankfurt am Main. That event brought together around 170 participants from the industry, regulatory bodies and academia, with attendees coming from across Europe, North America and Asia. The conference consisted of **two keynote speeches and three panel sessions**, in which participants discussed issues relating to the global nature of central counterparties (CCPs), CCP liquidity needs and the role of central banks of issue (CBIs), as well as approaches to member defaults and default management. In order to encourage open discussions, the conference was held under the Chatham House Rule.

Benoît Cœuré, ECB Executive Board member and Chairman of the global Committee on Payments and Market Infrastructures (CPMI), opened the conference with a keynote speech entitled “The case for cooperation: cross-border CCP supervision and the role of central banks”.¹ He made the case for enhanced cooperation between authorities with regard to the oversight of CCPs that are systemically important for multiple jurisdictions and stressed the need to strike a balance between facilitating cross-border access and safeguarding authorities’ ability to carry out their statutory tasks. He urged all jurisdictions to step up their efforts to put in place cooperative oversight arrangements and crisis management groups for all major global CCPs, in line with international standards. As regards the role of CBIs, Mr Cœuré highlighted the interaction between central clearing and core central bank objectives and the scale of the potential funding needs if a major global CCP were to become distressed. Against this background, he emphasised that the Eurosystem required adequate safeguards to ensure that CCPs were properly protected against euro liquidity risks.

¹ See <https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190227~cf2acdb23d.en.html>

1 Panel Session on the global nature of CCPs

The **first panel session** on the **global nature of CCPs from a regulatory and supervisory perspective** began with a discussion looking at the monitoring and management of systemic risk.

Panellists identified three key factors in the effective mitigation of systemic risk. First, CCPs should employ high standards in respect of risk management and governance. Specific areas mentioned in this regard included robust membership criteria, measures to mitigate the procyclicality of margining and collateral policies, and the need to take account of idiosyncratic risks in individual products. Second, there should be broad diversification of clearing members and products in order to avoid concentration and wrong-way risk within a CCP. And third, regulation and supervision should be proportionate, predictable and clearly defined, especially with regard to cooperation in times of crisis, when rapid action is essential, and there should not be “too many hands on the steering wheel”. In this context, panellists were in agreement regarding the importance of fire drills and stress testing in terms of promoting preparedness, and they agreed that such exercises should involve both CCPs and the relevant authorities. One member of the audience remarked that underlying stress scenarios could include cases where the underlying problem was a liquidity issue, rather than a solvency issue.

Panellists also considered the extent to which the mitigation of systemic risk should involve CCPs having access to central bank facilities. The point was made that CCPs’ differing liquidity risk profiles should be taken into account in this context, depending also on the types of product cleared. While one speaker stressed that repo markets could cease to function in a crisis and that CCPs should therefore have standing, non-discretionary access to the lending facility, another speaker felt that such access would only be needed in extremely severe circumstances and that reliance on standing access to central bank liquidity could call into question the robustness of the CCP’s own liquidity risk mitigation. However, speakers agreed on the benefits of regular access to central bank deposit facilities in order to mitigate the custody and investment risks entailed by reliance on commercial banks.

The panel then discussed the issue of market structure, looking at how to reconcile the competing objectives of reaping netting efficiencies and reducing single-point-of-failure risks. Two panellists underlined the importance of competition, in order to avoid “putting all your eggs in one basket”, although they acknowledged that competition could only be sustained where alternative options were economically viable – and this, in turn, would depend on the depth and liquidity of the underlying market. Another panellist argued that, even if it was highly concentrated, a market structure where CCP participants were actively involved in the CCP’s risk management decisions should be less of a concern from a risk perspective. Panellists also had differing views on the factors that should drive inter-CCP competition. While one panellist considered that cost efficiency and product range were the most important factors, another argued that CCPs should compete on the basis of having the highest risk management standards and should therefore be as transparent as possible regarding their risk management

practices. In general, there was broad agreement that the behaviour of clearing participants should not be dictated by regulation and that the market should be allowed to move freely.

The panel also discussed issues relating to supervisory and oversight cooperation across jurisdictions. One panellist stressed the importance of avoiding potentially conflicting and unnecessarily complex requirements. That panellist argued that such problems had been acknowledged in the United States and had recently prompted a move towards greater regulatory deference for some third-country CCPs, while regulatory requirements for systemically relevant third-country CCPs were expected to be tightened significantly under EMIR 2 in the European Union. However, given that EMIR 2 and the accompanying Level 2 rules are still being drafted at this point, the importance of maintaining dialogue and not rushing to conclusions at this stage was also stressed, in the light of past examples of good, close cooperation between authorities. From a market perspective, the challenge posed by differences in the speed of implementation of international standards across different jurisdictions was noted. It was suggested that enhanced cooperation between authorities would be helpful in this regard.

The panel session ended with a general overview of Brexit preparations and a look at the potential implications of Brexit for the clearing industry around the world, with a particular focus on London and the EU. Panellists acknowledged the rapid steps taken by relevant authorities in order to alleviate uncertainties and concerns resulting from the United Kingdom's departure from the EU. They agreed that market players had made extensive preparations and now considered themselves ready – even for the worst-case scenario of a no-deal Brexit. While the potential impact on CCPs' volumes could not yet be determined, it was emphasised that UK banks had taken considerable steps to secure their access to the EEA market post-Brexit, notably by transferring business to EU affiliates. One speaker pointed out that, in a similar vein, EU banks were also looking to use their UK branches in order to continue accessing the UK market. Overall, speakers were confident that the implications of Brexit would be manageable from a financial risk perspective and that, in the long run, the new financial setting resulting from Brexit would eventually evolve into normality.

The first panel session was followed by a keynote speech by **Dietrich Domanski**, Secretary General of the Financial Stability Board (FSB).² Mr Domanski began by talking about the expansion in central clearing that had followed the decision to move towards mandatory central clearing for standardised over-the-counter (OTC) derivatives after the 2008 global financial crisis and public authorities' subsequent focus on ensuring that the increased systemic risk concentrated in CCPs was monitored and managed appropriately. He noted that the post-crisis reforms to OTC derivatives markets need to be viewed as part of the wider post-crisis reforms of the financial system. In terms of areas for further policy development, he talked about (i) issues relating to the adequacy of financial resources and the treatment of equity in CCP resolution, and (ii) continuing implementing international standards (e.g. the establishment of dedicated CCP resolution regimes in all FSB member jurisdictions

² For his profile and the full speech at the conference see <http://www.fsb.org/profile/dietrich-domanski/>

and cross-border crisis management groups for resolution planning for major global CCPs). Mr Domanski also updated on the FSB's ongoing work to evaluate the effects of the post-crisis reforms and on implementation of reforms to address too-big-to-fail risks. He noted that an evaluation of OTC derivatives markets reforms had concluded that the reforms are providing incentives for central clearing.³

2 Panel Session on CCP liquidity and the role of CBIs

The **second panel session** focused on **CCP liquidity and the role of CBIs**. It began with a discussion looking at CCP liquidity needs in the event of business as usual and in extreme (but plausible) circumstances. One speaker explained that liquidity risk management could usually be implemented smoothly in the course of normal business as a “zero-sum game” of incoming and outgoing payments. Of course, CCP liquidity risks can nevertheless arise, notably because of liquidity providers failing to meet their payment obligations in a timely manner, a default by a major clearing member, or other types of market disruption, including those resulting from major political events. However, CCPs have various liquidity backstops in order to deal with such scenarios and ways of controlling their liquidity flows as the “ultimate arbiters” of the relevant rules (e.g. rules on the types of product cleared, the collateral accepted and the service providers used). At the same time, CCPs also aim to ensure that they collateralise positions in an optimal manner so that necessary liquidity is not drained from the system by overfunding positions.

As regards CCPs' liquidity needs on “rainy days”, panellists focused on issues surrounding cross-border and cross-currency settlement, the liquidity risks embedded in specific products such as repos, and the potential stigma associated with accessing the central bank's lending facility. Another issue raised was that of failing service providers, notably in view of the high levels of concentration in the provision of services to CCPs.

Concerns were raised by clearing members regarding the procyclical nature of intraday variation margin (VM) calls. In addition to worries regarding the potential for large VM calls in volatile market conditions, it was noted that CCPs could call for VM intraday while not paying out VM gains to their members intraday. In defence of this process, one panellist pointed out that intraday margin calls were a key part of CCPs' risk management and were clearly explained in the rulebook, so members knew all about them in advance. On the issue of how to effectively manage liquidity across currencies and time zones, another panellist emphasised that CCP liquidity risks had to be managed by currency and that, accordingly, their CCP had arrangements in place with the commercial sector in each currency.

While panellists agreed that regulatory frameworks and CCP practices in the area of liquidity risk management had developed significantly in recent years – especially compared with the days when liquidity risk had been considered a mere ancillary to

³ See <http://www.fsb.org/2018/11/incentives-to-centrally-clear-over-the-counter-otc-derivatives-2/>

credit risk – they also pointed to areas where further work was needed, such as the development of liquidity stress scenarios and arrangements for covering liquidity shortfalls in extreme market conditions. In this context, greater attention should also be paid to the liquidity risk implications of non-default scenarios, such as those resulting from a service outage following a cyberattack. Given the high degree of interdependency between CCPs and the fact that CCPs' liquidity risk management efforts focus on self-protection, rather than wider systemic contagion effects, speakers also advocated multi-CCP fire drills to test the systemic resilience of liquidity arrangements. In addition, panellists also argued that there was a need for greater transparency and communication regarding CCPs' liquidity risk management, in relation to both clearing participants and the relevant authorities (e.g. as regards the findings of CCPs' liquidity risk fire drills). Finally, panellists also touched on the potential challenges of managing liquidity risk in a less expansionary macroeconomic environment.

The panel then discussed CBIs' role in helping CCPs to manage their liquidity. Speakers agreed on the importance of CCPs having both robust protective measures of their own in each relevant currency and access to central bank liquidity on a secured basis for exceptional situations where market-based solutions might not be fully workable. The point was also made that CCPs have a finite amount of information and are ultimately accountable only to their specific constituencies (clearing members, shareholders, etc.) while central banks (and regulators more generally) have access to broader system-wide information that can help with the assessment of liquidity issues. Moreover, it was argued that CBIs needed to play a role given that financial risk is now concentrated in a small number of global institutions, and their failure could affect the fulfilment of CBIs' monetary mandates, particularly in view of (i) the role that clearing members play as monetary policy counterparties, (ii) CCPs' relevance for the functioning of repo markets (as clearers and investment counterparties), which is essential for the transmission of monetary policy, and (iii) the role that CBIs play as potential lenders of last resort to clearing members and/or CCPs.

At the same time, it was acknowledged that CBIs could not be expected to accept responsibility without appropriate safeguards. The key issue in this context would be early CBI involvement before matters became critical. Ongoing access to sufficiently granular information on CCPs' exposures and risk management (e.g. as regards currency-specific stress scenarios) was mentioned as a key prerequisite in this regard. In addition, CBIs should be involved in a meaningful manner in the ongoing supervisory process, as well as recovery and resolution planning. Close cooperation between CBIs, supervisors and resolution authorities was regarded as being crucial, but in many cases the relevant global standards had not yet been implemented.

Panellists also discussed the broader issue of how preparedness for the management of serious CCP liquidity strains could be improved. One speaker argued that informal arrangements and ad-hoc decisions had worked well in the past and that formal arrangements could in fact be a hindrance rather than a help. Countering that point, another speaker emphasised the need for clarity regarding the menu of possible actions well in advance of major stress scenarios. Speakers then briefly debated the idea of enhanced information sharing between central banks as one way of

approaching this issue. While speakers were broadly supportive, some raised concerns, pointing out that it was important that CBIs did not use and act on such information in an uncoordinated manner.

3 Panel Session on member defaults and default management

The **third and final panel session** of the conference considered issues around **CCP member defaults and default management**. In the light of the lessons learned from past defaults and near-defaults, panellists agreed that effective arrangements for loss mutualisation were essential, as initial margins would not cover the tail risks of cleared products.

Panellists agreed that arrangements needed to differ across CCPs, depending, for example, on the risk characteristics of the relevant product, the size of the liquidity pool, the number of participants and the concentration of membership.

It was argued that robust default management arrangements were generally characterised by three features: (i) transparency regarding stakeholders' responsibilities in the default management process; (ii) effective measures promoting active engagement in auctions on the part of participants; and (iii) a holistic, forward-looking approach as regards preparing for and managing risks in default scenarios.

In terms of transparency, CCPs' rules should be very clear on the roles and responsibilities of the CCP, clearing members and clients (e.g. as regards mandatory vs voluntary participation in auctions), as well as regarding areas where a CCP could potentially show discretion. There should also be clarity regarding the circumstances in which a CCP may prefer liquidation to auctions and the type of loss and position allocation tools that may be employed if an auction fails. Default management arrangements should also provide for appropriate involvement of relevant authorities and be tested in regular fire drills to ensure their smooth functioning.

On the subject of participants' engagement in auctions, panellists agreed on the challenges arising from the diverse incentives of CCPs, clearing members and clients. In particular, while clearing members may be incentivised to provide competitive and early bids in order to preserve the default fund, default fund protection may not be a priority for clients. On the other hand, clients may have strong incentives as a result of large directional positions and their role as liquidity providers.

Panellists had differing views on whether measures to incentivise participant engagement should focus more on rewards or penalties. It was emphasised that this would depend largely on the type of product and market structure. It was also argued that incentive structures could change as new participants joined central clearing. In principle, however, it was agreed that, while models involving mandatory auction participation were essential for OTC derivatives, their use for cash and debt products was generally more challenging. Panellists also agreed that optimistic assumptions regarding the potential role of a "white knight" voluntarily taking up the positions of a defaulting member could often prove unrealistic in the light of related capital leverage

ratio constraints. One panellist suggested that a temporary suspension of certain regulatory requirements could facilitate a CCP's default management process by ensuring sufficient balance sheet capacity for clearing members.

Panellists mentioned various key factors in ensuring active participant engagement in auctions, including robust rules regarding mandatory participation, pre-agreements supporting effective voluntary participation and good governance arrangements. Moreover, regular discussions within risk committees (e.g. with a view to jointly assessing the lessons learned from periodic fire drills) were also deemed essential in this context. As a complementary tool, it was felt that the establishment of default management committees involving external stakeholders could also be helpful, as relevant trading expertise could often be found outside the CCP.

Finally, in terms of a holistic, forward-looking approach to default management, three issues were emphasised by panellists: (i) the need to prepare, in cooperation with the relevant authorities, for the liquidation and hedging of the positions of a troubled clearing member before that member is placed in default; (ii) the need for greater coordination across CCPs in terms of preparing for and managing member defaults; and (iii) the need to ensure the ability to cope with potential liquidation costs by monitoring the overall size of risk exposures (in terms of the CCP's gross position), coupled with add-ons in the margin process and position limits if necessary.

Conclusion

In conclusion, the discussions regarding the global nature of CCPs, their liquidity needs, the role of CBIs and CCP default management focused on three key areas:

- With regard to **CCPs' own risk monitoring and management**, participants acknowledged that significant improvements had been made in recent years and stressed the need for ongoing vigilance and further efforts to bring CCPs' liquidity risk management procedures for stress scenarios up to the same level as their credit risk management procedures. CCPs should ensure that their interaction with clearing participants is effective by means of (i) robust membership requirements, (ii) high standards of corporate governance, and (iii) transparency regarding risk management practices. In addition, CCPs' frameworks for default management should be developed further, acknowledging the diverse incentives of CCPs, clearing members and clients.
- With regard to the **role of authorities**, participants agreed that regulation and supervision should be proportionate to the risks incurred and should not seek to interfere directly with market structures. Effective arrangements for global CCPs should aim to promote market access and enable authorities to fulfil their respective mandates. While there is a close link between central clearing and monetary policy, and CBIs can play a role in reducing liquidity strains (particularly in tail risk situations), this should not call into question CCPs' responsibility to ensure comprehensive liquidity protection in line with international standards. At

the same time, CBIs need appropriate safeguards in terms of access to information and the ability to influence CCPs' risk management at an early stage. Existing global standards for cooperation between authorities should be implemented in full as soon as possible.

- A common challenge and priority for both CCPs and the relevant authorities is the need to enhance **preparedness for stress scenarios** – e.g. through regular fire drills, crisis simulation, stress-testing exercises and the development of cooperative information-sharing and coordination arrangements. In addition, efforts to promote better understanding of risk exposures across CCPs should be continued.

The three organisers of this event – the Deutsche Bundesbank, the European Central Bank and the Federal Reserve Bank of Chicago – look forward to revisiting these issues and discussing other relevant developments at their next joint CCP conference.