Derivatives and Systemic Risk

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CCPs And Systemic Risk Management Today

Traditionally CCPs serve as a shock absorber against the impact of member defaults.

- **In a default, the CCP steps in and assumes the defaulted member's portfolio.**
- **CCP continues to meet the VM payments to non-defaulted members.**
- **Defaulted member's portfolio is then closed out (auctioned).**
- **Process follows a strict protocol, with tools and process laid out in the CCP Rulebook.**
- **Serves to limit the potential contagion risk from the default event.**

Key Systemic Risk Tools In Use At CCPs Today

- **Minimum credit standards for membership.**
- **“Cover 2”.**
  - **Must be enough financial resources to cover the default of largest 2 members.**
- **Concentration risk charges.**
  - **Discourages outsize risk from individual members, as margin grows with position size.**
  - **Challenging to implement for derivatives CCPs esp. in light of clearing mandates.**
  - **Can include charges on use of default funds (and liquidity resources) to prevent any one member using too much of the total mutualised pot.**
- **Procyclicality constraints.**
  - **Handle trade-off between being under-margined for short period vs. raising margins too quickly in a severe market move.**
  - **Implies CCP needs to hold on to some margins in “good times”, so margins will not jump too much in a stress event.**
- **Default Management**
  - **Assessment powers**
  - **VMGH**
  - **(Partial) Contract tear-ups**

Mature CCPs Face New Challenges

Gradual decline in member balance sheet capacity caused by more stringent capital and liquidity charges, leads to:

- **Declining FCM population to support client clearing.**
- **Client porting now potentially more difficult.**
- **Storing member margins safely also more difficult.**
  - **Under EMIR, CCPs cannot use money market funds and are required not to have more than 5% of margins unsecured with a commercial banks.**
  - **Effectively the remaining 95% must be in reverse repo or the relevant Central Bank.**
  - **But repo capacity (secured lending) has declined.**
  - **Without access to the Central Bank in the relevant currency, this results in increased unsecured deposits at commercial banks during a stress event.**

Mature CCPs Face New Challenges (Contd.)

- **Traditional focus on clearing member defaults now changing:**
  - **Clearing member defaults have well developed remedies enshrined in CCP Rulebook.**
  - **Losses from clearing member defaults will be fully allocated by the CCP Rulebook, though some existing tools may have systemic consequences which may need to be addressed.**
  - **Non Default Losses (NDLs) more problematic: member margins and traditional Rulebook powers are usually off-limits as a solution.**
  - **Absorption of NDLs a critical area of current focus.**
  - **No "one size fits all" solution for NDLs.**
- **As a consequence, Operational Risk discipline at CCPs is developing rapidly.**
- **Key CCP relationships in the financial ecosystem not yet fully mapped and understood:**
  - **Interactions with Repo markets**
  - **Interactions with other PFMIs (ICSDs).**
  - **Interactions with Central Banks.**
    - **QE impact on CCPs. (distorted risk premia, momentarily unbalanced CCP, source of procyclicality….).**
    - **Difference between CCP deposit account at a Central Bank and ability to repo with Central Bank.**
- **CCP Recovery and Resolution – Many open issues**
  - **Who is the Resolution Authority for a CCP? What is relationship to the CCP Regulator?**
  - **When should the CCP be put into Resolution?**

Potential Role for ESRB

- **Provide holistic view to ensure that:**
  - **The various micro prudential initiatives undertaken to regulate CCPs are consistent with the overall goal of financial stability.**
  - **The various micro prudential initiatives undertaken to regulate CCPs are not in conflict with each other.**
  - **Macro prudential policy is consistent with the micro prudential supervision carried out by CCP regulators.**
  - **The impact of any macro prudential actions takes into consideration the likely impact on CCPs.**
  - **That regulatory activities do not force private capital away from funding CCPs and leave the public sector (tax payer) as the only source of capital.**