Derivatives and Systemic Risk

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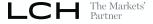
CCPs And Systemic Risk Management Today

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.

