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Financial Stability Board
Bank for International Settlements

Via Email: fsb@fsb.org

Re: Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution

Ref no: 15/2020

Ladies and Gentlemen

To verify if regulatory measures, same as risk management, achieve its objectives the most basic method is back-testing: were regulatory measures capable to cover past events if they had been in place at that time already, achieved stated objectives fully/partially/not at all. If the answer is no, regulatory measures should be amended, complemented and in the most extreme case a complete overhaul might be required.

Financial market dislocations in mid-March 2020 provide a good opportunity for back-testing. BIS has executed several such tests already, for example "The CCP-bank nexus in the time of Covid-19". CCP resolution regime should also be evaluated using mid-March conditions.

Covid-19 pandemic accelerated an "unprecedented situation", but it is not the first systemic dislocation recently: Asian crisis, Russia-LTCM default and GFC, to name just a few. Plus, Covid-19 is only the accelerator. The root of the crisis is cyclicality of financial markets, and the trigger in 2019 was changed regulation, as outlined in BIS Quarterly Review "September stress in dollar repo market: passing or structural?" What all volatility events have in common, dislocations were substantial enough to destabilise the financial system as a whole.

Covid-19 pandemic requires massive intervention by central banks and governments internationally. Without these interventions default cascade had started already: private households and non-financial corporations (NFC) drive banks, insurance companies and finally FMI provider such as CCPs into default as well.

Regulatory regime in general, and that includes financial resources to support CCP resolution, as of today is not capable to cope with such volatility events, has not passed back-testing. CCP resolution only works if the financial system as a whole stays stable during whole resolution process. The path of CCP resolutions in stable versus unstable environment is extremely narrow. In case of unknown or unquantifiable risks, determining the correct level of equity required in advance literally impossible. Even under the best regime and mathematical model available, success rate very limited. Central bank and state support are still essential, TBTF not addressed.

Limitation is even more obvious assuming two or more volatility events occur in short order, e. g. G-SIB default followed by CCP imbalance or sovereign defaults due to ballooning debt levels as experienced following GFC.

Key lessons to be learned from mid-March dislocations are:

1. unprecedented situations happen more often than most people and models predict
2. path to address unprecedented situation within the financial system is very narrow
3. CCP regulatory regime inadequate to cope with systemic imbalance/market failure

One possible solution, complement regulatory regime, and widen focus to include innovative structures outside financial system as well. Hence allow CCP capital to melt away fully for example and relieve resolution regime.

In response to FSB consultation 13/2019 “Evaluation of too-big-to-fail reform” M|E|W Consul outlined in letter June 14, 2019 advantages of additional facilities: liquidity/collateral (KLF) and regulatory capital reserve (RCR).

As a reminder, financial system is cyclical, thereby inherently instable, in case of volatility event does not return to stable equilibrium. Regulation incl. increased CCP derivative settlement and capital/collateral support amplify cyclicality. Required is an automatic counter-cyclical stabiliser or firewall, as confirmed by current BIS Bulletin “The CCP-bank nexus in the time of Covid-19”. Spill-over effects, “volatility-leads-volatility” and increased correlation during volatility events have been thoroughly analysed. In mid-march, same as at all “unprecedented situations” before, only massive central bank intervention could avoid volatility event to spin out of control.

In combination with the additional liquidity/collateral and capital facilities developed, for the 1st time whole CCP capital base could be used for resolution with limited spill-over effect. And as BIS Working Paper “Model risk at central counterparties: Is skin-in-the-game a game changer?” demonstrates, capital at risk has the biggest impact on CCP management.

Experiences during mid-March 2020 dislocations confirm necessity of automatic stabiliser beyond any doubt.

For non-financial corporations (NFC) and smaller financial institutions (FI) settlement of automatic stabiliser can be G-SIB and CCP based. In case of G-SIB and CCP, coverage only works in combination with independent FMI: deposit, payment and settlement.

On June 20, 2019 than governor Mark Carney suggested Bank of England could open its vaults, granting access to tech companies. In combination with instant FMI that would be sufficient, as central banks are already in the process of implementing private sector independent payment and HQLA settlement systems: FedNow initiative by Federal Reserve Bank, TIPS by ECB and others.

Step by step necessary infrastructure is established to allow introduction of financial system independent safety architecture such as KLF and RCR to also cover CCP, G-SIB, major insurance companies and asset managers.

Following implementation of automatic stabiliser, central bank and state support might still be needed in case of future “unprecedented situation”, but an additional layer would be in place. Since the additional infrastructure will be 100% private capital based, next step of true burden sharing of “unprecedented situation” and limiting TBTF is achieved.

So far banks and FMI providers successfully block innovation, thereby secure TBTF status = publicly financed protection. Strategy paid off, massive intervention by central banks and governments avoided insolvency cascade to start - at least temporarily.

Since this year last missing part necessary available, Bank for International Settlements Innovation Hub allows circumventing resistance by banks and FMI providers without competitive distortion or changes to regulatory and legal framework, etc.

Summarised, current regulation has not passed back-testing. Mid-March “unprecedented situation” and financial market dislocations did not allow CCP resolution, central banks and state intervention were necessary to stabilise financial system - at least temporarily. CCP must be ring fenced. Prerequisite, financial system independent FMI: deposit, payment and settlement. Following ring-fencing resolution is possible exhausting 100% of capital, guarantees, etc. as outlined in “Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution”.

Considering the massive expansion of central bank balance sheets and national debt for temporary stabilisation of the financial system demonstrates the imperative to act fast. A second wave Covid-19 would probably test the limits of current system already.

Next step, test-run innovative automatic stabiliser structures developed (proof-of-concept), using BIS Innovation Hub as platform.

Regulatory regime and financial resources to support CCP resolution as of today are insufficient. But necessary independent financial market infrastructure in place to enforce change and to built required automatic stabiliser. Thereafter, 100% of CCP capital can be exhausted in case of resolution.