FSB FINANCIAL STABILITY BOARD

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CCP resilience, recovery and resolution: completing the journey towards resilient derivatives markets

Deutsche Bundesbank, European Central Bank and the Federal Reserve Bank of Chicago Conference on CCP Risk Management[1]

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Remarks by Dietrich Domanski, Secretary General, Financial Stability Board

Ladies and gentlemen, it is good to be here today. The Deutsche Bundesbank, European Central Bank and the Federal Reserve Bank of Chicago have shown real leadership in convening this conference.

Today's agenda shows that we have come a long way in reforming derivatives markets. Almost ten years ago, at the Pittsburgh Summit in September 2009, G20 Leaders declared that all standardised over-the-counter (OTC) derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. The declaration made central clearing an essential element of the reforms to reduce the complex and opaque web of exposures that existed between derivatives counterparties.

Since then, we have put in place a framework to fundamentally reform derivatives markets. This includes measures related to central clearing, but also policies to enhance the transparency and resilience of markets for non-centrally cleared derivatives, through trade reporting and margin requirements.

Yet derivatives markets reform is only one key area of post-crisis regulatory efforts. There is also significant progress in making the banking system more resilient; implementation of too-big-to-fail reforms is advancing, including via the establishment of effective resolution regimes for banks; and those aspects of non-bank financial intermediation that contributed to the financial crisis have declined significantly and generally no longer pose financial stability risks.

But, as today's conference shows, important issues still lie ahead. What I would like to do in my remarks is to put CCP-related reforms into perspective – by looking back at what we have accomplished, and discuss what remains to be done from the perspective of the FSB; and by relating CCP-related policy measures to progress in other areas.

What we have accomplished?

CCPs have become central to the global financial system

Let me begin with a few simple numbers that illustrate how central CCPs have become for the financial system. In 2009, the clearing level was around 24% for interest rate derivatives and

[1] The views expressed in this speech are those of the speaker and do not necessarily reflect those of the FSB or its members.

just 5% for credit derivatives. By June 2018 these levels had risen to approximately 62% for interest rate derivatives and 37% for credit derivatives. Today, 90% of new OTC single-currency interest rate derivatives are now centrally cleared in the US.

This impressive shift has been accompanied by the enhancement of legislative or regulatory frameworks to promote central clearing. Such frameworks, including comprehensive standards for determining when OTC derivatives should be required to be centrally cleared, are now in place in 18 FSB jurisdictions. Our latest annual report shows a continued broadening of the range of asset classes that are centrally cleared.

Policy measures to promote central clearing are working. Last year, the FSB, Basel Committee on Banking Supervision (BCBS), Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) published the results of its evaluation of the incentives to centrally clear OTC derivatives.[2] The report found that the reforms – particularly capital requirements, clearing mandates and margin requirements for non-centrally cleared derivatives – are achieving the goal of promoting central clearing, especially for the most systemic market participants. However, the report also found that beyond the systemic core of the derivatives network of CCPs, dealers/clearing service providers and larger, more active clients, the incentives are less strong.

Significant work has been devoted to CCP resilience, recovery and resolvability

The shift to central clearing has made CCPs both larger and more systemic. Cognizant of their even more central role in the financial system, authorities have made significant efforts to ensure that CCPs are safe and sound. The CPMI-IOSCO *Principles for Financial Market Infrastructures* (PFMI) are a milestone in this regard. In July 2017, the FSB working with CPMI, IOSCO and the BCBS completed a workplan on CCP resilience, recovery and resolvability.[3]

The three reports coming out of the workplan provide guidance on a broad range of issues:

- CPMI and IOSCO set out further guidance on the PFMI regarding resilience of CCPs, in particular on governance, credit and liquidity stress testing, coverage, margin, and a CCP's contributions of its financial resources to losses.
- CPMI and IOSCO also updated their 2014 guidance on recovery for financial market infrastructures to provide clarifications in a number of areas including the operationalisation of recovery plans and non-default related losses.
- And the FSB published guidance on how to implement its Key Attributes in resolution arrangements for CCPs.

Taken together, this guidance reflects a clear recognition of how important strong CCP risk management, effective oversight of CCPs, and workable arrangements for the recovery and

[2] FSB, *Incentives to centrally clear over-the-counter (OTC) derivatives*, November 2018 (http://www.fsb.org/2018/11/incentives-to-centrally-clear-over-the-counter-otc-derivatives-2/)

[3] FSB, *International committees complete the April 2015 workplan on central counterparty resilience, recovery and resolvability,* July 2017 (http://www.fsb.org/2017/07/international-committees-complete-the-april-2015-workplan-on-central-counterparty-resilience-recovery-and-resolvability/)

resolution of CCPs are for financial stability. What is important now is that jurisdictions move forward with timely and effective implementation of this guidance.

We have enhanced our understanding the risks around central clearing

Financial reforms around central clearing have fixed the main fault lines exposed by the financial crisis in derivatives markets. Increased clearing has simplified the previously complex and opaque web of derivatives exposures. The CCPs supporting that clearing are more resilient. In addition, more collateral is in place to reduce counterparty credit risks within the system. Some estimates suggest that an additional $1 trillion of collateral is now held globally against all derivative trades.[4]

At the same time, the shift to central clearing has made the financial system more interconnected. This may change the nature of systemic risks. FSB, CPMI, IOSCO and BCBS have analysed the relationships between 26 of the largest CCPs globally and their clearing members. The last report which was published in August 2018 confirms that a failure at one of these central elements of a CCP network would likely have significant consequences for the rest of the network:

- The mapping of relationships shows a core of highly connected CCPs and entities and a periphery of less highly connected CCPs and entities. And, even the less highly connected CCPs often are linked to at least one highly connected entity.
- Exposures to CCPs are concentrated among a small number of entities. The largest 11 clearing members are connected to between 16 and 25 CCPs. This implies that the default of one CCP clearing member could result in defaults of the same entity or its affiliates in up to 24 other CCPs.
- Pre-funded financial resources – initial margin and default fund – are concentrated at a small number of CCPs. The two largest CCPs account for nearly 40% of total prefunded financial resources provided to all CCPs.

These findings will not have been a big surprise to people familiar with central clearing. Still, having these relationships mapped and better understood with robust data and rigorous analysis at a global level is an important step to ensuring greater transparency in the financial system. Understanding the nature of interconnectedness is valuable for both CCP risk managers and supervisors. And for regulators, it serves as a reminder that the resilience of CCPs and major clearing members are intertwined.

[4] FSB, *Review of OTC derivatives market reform: Effectiveness and broader effects of the reforms*, June 2017 (http://www.fsb.org/2017/06/review-of-otc-derivatives-market-reform-effectiveness-and-broader-effects-of-the-reforms/)

What remains to be done?

Now, considering all this progress, what remains to be done? The answer is: some remaining work on policy development, and quite a bit more on implementation and evaluation. Let me briefly discuss these three areas in turn.

Policy development: Ensuring adequate financial resources and the treatment of CCP equity in resolution

CCP resolution continues to be a challenging topic, with complex debates around issues such as the use of variation margin gains haircutting,[5] resources and responsibility for non-default losses, and the boundary between recovery and resolution. Also, the liquidity aspects of CCP stress have not been as much discussed so I look forward to the next session.

In November last year the FSB published a discussion paper, in consultation with the CPMI and IOSCO, on financial resources to support CCP resolution and the treatment of equity in CCP resolution.[6] The consultation set out considerations to evaluate whether existing financial resources and tools are adequate to implement resolution strategies for individual CCPs; and the considerations that could guide authorities in developing possible approaches to the treatment of CCP equity in resolution. Responses to the public consultation, along with the experience of authorities in evaluating financial resources for resolution, will help inform the development of guidance by end 2020.

I am not going to say much more as we need to consider our next steps based on the responses we have received, which are now posted on the FSB website.[7] I know that a number of participants at today's conference either responded to the consultation or took part in meetings we have held about the discussion paper. I'd like to thank you for the useful inputs that have been provided.

These are topics where – fortunately – we do not have much recent experience to draw on. On the one hand this is a measure of success of CCPs. But on the other, the events at Nasdaq Clearing last September remind us that stress events can have unexpected outcomes and there is no room for complacency.

Standards implementation: complete the adoption of central clearing frameworks

Progress continues in enhancing the regulatory frameworks for CCPs, including in cross-border aspects such as deference decisions in relation to CCPs, and in setting expectations for their sound design and operation consistent with the PFMI by CPMI and IOSCO. For example,

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[5] Variation margin gains haircutting is a loss allocation tool whereby a CCP reduces or 'haircuts' the variation margin payments that it is due to make to participants whose positions (in the relevant clearing services) have increased in value since a specified point in time, e.g. since the issuance of a default notice by the CCP or the last margin call by the CCP. (Participants whose positions have decreased in value are still required to pay variation margin in full.)

[6] FSB, *Financial resources to support CCP resolution and the treatment of CCP equity in resolution*, November 2018 (http://www.fsb.org/2018/11/financial-resources-to-support-ccp-resolution-and-the-treatment-of-ccp-equity-in-resolution/)

[7] http://www.fsb.org/2019/02/public-responses-to-consultation-on-financial-resources-to-support-ccp-resolution-and-the-treatment-of-ccp-equity-in-resolution/

CPMI IOSCO's Level 1 implementation monitoring reports show that 25 jurisdictions have fully implemented the PFMI in relation to CCPs. The most recent FSB progress report on implementing OTC derivatives reforms notes deference decisions in relation to 16 FSB member jurisdictions.

More needs to be done across the FSB's membership to implement requirements on recovery and resolution. In Europe we look forward to further progress being made on legislation when a new Parliament and Commission are in place later this year. The European Commission as a member of the FSB and European Parliamentarians have shown a clear desire to implement the international standards. Some other jurisdictions do not yet have in place a comprehensive resolution regime for CCPs.

Crisis Management Groups (CMGs) are a key component in ensuring appropriate resolution arrangements are in place, given the cross border activities of many CCPs. Authorities have begun to establish CMGs for CCPs that have been identified as systemically important in more than one jurisdiction. CMGs and institution-specific cooperation agreements that underpin their operation are not yet in place for all such CCPs and resolution planning for CCPs is still at an early stage.

For CCPs that are systemically important in more than one jurisdiction resolution plans should be developed by the home resolution authority and coordinated within the CMG or equivalent arrangements.

Rapid progress in implementation is important. A lack of effective and timely implementation of the guidance on CCP resilience, recovery and resolution would considerably limit the toolkit that supervisors have to address CCP risks.

Evaluation: understanding the effects of reforms on central clearing

The evaluation of the effects of reforms is a new, key area of FSB work. Assessing the effects of policies should be an integral part of policymaking. The objective of such evaluations is to assess if reforms are working as intended and in an efficient manner, and to identify areas where adjustments may be appropriate to address material unintended consequences, but without compromising on agreed levels of resilience. In July 2017, G20 Leaders endorsed the FSB framework for the evaluation of post-implementation G20 financial reforms.

One of the first two evaluations under the FSB framework was on the incentives to centrally clear derivatives. I already mentioned that the study confirmed that policies that promote central clearing are working. But it also showed that regulators may face trade-offs: the evaluation found that including client margins in the leverage ratio creates a disincentive for central clearing. The Basel Committee has been consulting on the question of whether, and how, there is a case for changing the treatment of client margins in the leverage ratio in light of this finding.

CCPs will also play a role in another evaluation that the FSB is launching as we speak. This evaluation will examine the effects of too-big-to-fail reforms for banks. Notwithstanding the focus on banks, the evaluation consider implications for CCPs – reflecting the fact that global systemically important banks are the largest clearing members and key nodes in an interconnected financial system. It is of course way too early to talk about results of the evaluation. Work is starting, and the evaluation should be completed by late 2020.

Finally, let me mention our work on market fragmentation. This initiative – a priority under Japan's G20 Presidency in 2019 – is exploring the causes and financial stability implications of market fragmentation, and possible policy approaches to address possible unintended effects.

Conclusion

Let me conclude. The shift to central clearing has made derivative markets more transparent and risks better managed. At the same time, it is critical to understand CCPs as an integral part of an interconnected global financial system. This understanding is equally important for the proper design of CCP risk management; effective supervisory cooperation; and regulation that promotes financial stability.