

Recovery and Resolution of CCPs: let's bring the lifeboats in place

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Ladies and Gentlemen,

It is a great pleasure for me to be here today. First of all, I would like to thank the Banque de France for organising and hosting this conference and for inviting me to deliver this keynote speech.

Recovery and resolution of CCPs is still an unfinished chapter in many jurisdictions. Up to now, the first priority of regulators and supervisors has been to strengthen the resilience of CCPs, focusing among other things on the adequacy of their financial resources to ensure that they can withstand clearing member failures and other losses in extreme but plausible stress events. However, recovery plans by CCPs and resolution plans by authorities are essential for ensuring that CCPs can survive unpredictable market developments and avoid transmitting any systemic risk to financial stability. CCPs are now like seaworthy vessels heading for the ocean, but without the lifeboats in place.

At an international level, CPMI-IOSCO and the FSB have already issued guidance on recovery and resolution of Financial Market Infrastructures

(FMIs) covering also CCPs back in 2014. Moreover, the recovery and resolution of CCPs are important priorities of the ongoing international work plan on CCPs jointly launched in 2015 by the CPMI, IOSCO, the FSB and the Basel Committee. At EU level, the European Commission is expected to issue a proposal for a legislative regime on the resolution and recovery of CCPs towards the end of the year.

Therefore, this conference is very timely and I would like to take this opportunity to share with you my views on the important questions regarding recovery and resolution of CCPs that are being debated today.

CCPs are systemically critical infrastructures

Without doubt, CCPs are systemically critical infrastructures for financial stability, and supervision must ensure CCPs' resilience in extreme but plausible scenarios. This point was already made by the speakers in the first panel.

I would like to recall that during the events of the 2008 financial crisis, by netting exposures on a multilateral basis and absorbing losses with the financial resources collected through multilateral margins and default funds, CCPs avoided further transmitting the crisis to the markets they served. However, CCPs may themselves be a source of systemic risk, as the default of a CCP could detrimentally affect its participants. In turn this can, through a network of interdependencies, affect other CCPs and market infrastructures, which could potentially destabilise the markets they serve and beyond. This may threaten the stability of domestic and

international financial markets. CCPs are especially systemically critical the higher their interconnectedness and the lower their substitutability.

In the EU there are 17 CCPs operating in several market segments, including equities, bonds, energy, commodities, repos, clearing cash instruments and both exchange-traded and OTC derivatives. While a few CCPs offer clearing services in specific market segments, several EU CCPs are active in multiple market segments. Moreover, through their participants they often have cross-border interdependencies with trading venues and post-trading market infrastructures in other Member States or countries outside the EU. Some CCPs have also established interoperability arrangements that further increase the interdependencies with each other. Finally, the entry into force of the clearing obligation for interest rate and credit derivatives will further increase the reliance of markets on CCPs. Last Tuesday the first phase of the clearing obligation for interest rate derivatives in the G4 country currencies started for existing clearing members.

I am therefore convinced that EU CCPs are systemically important for the EU financial markets, albeit some more than others. It is thus critical for the stability of EU financial markets that CCPs are resilient to market shocks to avoid the creation of systemic risk.

EMIR enhanced EU CCPs' resilience in extreme but plausible market conditions

EMIR has introduced a common supervisory regime for CCPs in the EU. In line with the CPMI-IOSCO PFMI, this regulatory regime has

strengthened the resilience of EU CCPs through tight prudential requirements. In particular, EMIR requires EU CCPs to maintain pre-funded available financial resources enabling them to withstand the default of at least two clearing members under extreme but plausible market conditions, which is the well-known Cover-2 requirement. Further, minimum capital requirements have been introduced proportionate to the risks stemming from the activities of the CCPs. EMIR also requires that the Cover-2 pre-funded financial resources include a CCP's dedicated own resources, the so called skin-in-the-game requirement. Finally, the Regulatory Technical Standards (RTS) developed by ESMA provide granular requirements on the risk management framework of CCPs, including on the review of risk models, stress tests and back testing and, the framework for defining extreme but plausible market conditions.

However, strong rules are not enough. They should also be supervised in a credible and consistent manner. This is especially important in derivatives markets, which are arguably one of the segments of the financial markets most susceptible to regulatory competition. Small differences in requirements may affect where clearing takes place. Therefore, following the establishment of a single rulebook on CCP requirements, ESMA has promoted supervisory convergence for CCPs across the EU to ensure that they apply the requirements consistently under EMIR. We have used various measures to achieve convergence.

Firstly, through participating in CCP colleges, developing guidelines, opinions, Q&As and performing peer reviews of national competent authorities' supervisory activities, ESMA has contributed to the consistent implementation of EMIR. In particular, by participating in every CCP

college under EMIR we have a privileged overview of developments across EU CCPs. We have seen that, especially during the authorisation phase, EU CCPs have enhanced their risk frameworks to ensure compliance with the new requirements under EMIR.

Secondly, through validating significant changes to CCPs' models and parameters, ESMA has ensured that such changes do not affect a CCP's compliance with EMIR and, where relevant, we have identified areas for improvement to enhance such compliance.

Finally, through the EU-wide stress tests, which have been published recently, ESMA has assessed the resilience of CCPs to adverse market developments.

ESMA's EU-wide Stress Tests

Let me spend a few words on this latter exercise which was the first ever supervisory stress test of CCPs and has involved significant resources of ESMA, the National Competent Authorities and, last but not least, the EU CCPs included in the exercise. I would like to take this occasion to thank the EU CCPs again for their cooperation and contributions to the successful completion of the test.

This first EU-wide stress test assessed the resilience of 17 CCPs, including all authorised EU CCPs, for three dates in October, November and December 2014 with a focus on counterparty credit risk. The exercise was complemented with an analysis of the concentration of CCPs'

exposures and of the potential spill-over effects to non-defaulting clearing members.

Keeping in mind the limitations of the methodology applied in this first exercise, the results indicate that, for the three reporting dates used, overall the system of European CCPs is resilient to counterparty risks under the scenarios used to model extreme but plausible market developments. In particular, the prefunded resources of CCPs would be sufficient to cover the losses resulting from the considered historical and hypothetical market stress scenarios after the default of the top-2 EU-wide groups. A set of “modelled” market stress scenarios was also tested in combination with more severe member default scenarios, which produced more severe, although less plausible results. Moreover, the reverse stress test scenarios constructed by further increasing the number of member defaults have not revealed plausible scenarios with systemic impact. Also the analysis of the concentration of exposures in CCPs does not suggest emerging systemic risks at the CCP or EU-wide level. Finally, following the analysis of potential knock-on effects to clearing members, no systemic impact has been identified as the number of highly affected members is rather limited and the corresponding amounts not significant.

Nevertheless, ESMA has identified potential shortcomings and included two recommendations addressed to National Competent Authorities in order to conduct the necessary supervisory follow up. The first recommendation relates to the CCPs’ assessment of its clearing members’ creditworthiness. This assessment should take into account clearing members’ potential exposures due to their participation in other

CCPs. This goes back to my earlier point on the many interdependencies between CCPs.

The second recommendation relates to the price shocks used by CCPs in their own stress test methodologies. Indeed, from the analysis of the data provided by CCPs, ESMA identified that in a number of cases the price shocks applied by CCPs for some of their cleared products were not as conservative as the minimum shocks defined for the EU-wide stress test. Also, in some cases the price shocks were not reflecting the most extreme historic price changes observed. Where gaps have been identified, the relevant CCPs have been invited to review the price shocks applied in their own stress tests and to report the result of this review to their respective CCP colleges by the end of this year.

While I am satisfied with the achievements of this first stress test of CCPs, it is also fair to say that it had some teething problems. That is inevitable considering it was the first of its kind, and given the complexity of the issues at stake. ESMA is therefore committed to improve the methodology and extend the scope of its future annual stress tests. For example, I would hope that we are able to include liquidity risks in our next stress tests.

I now want to close this detour on the EU-wide stress test and return to today's topic: CCP recovery and resolution. Looking at the financial crisis, or even further back in history, the track record of CCPs is good and when talking about the cases where recovery and resolution were at stake, the same few cases that we all know are mentioned. However, an excellent past track record is not enough. Risks may not have come to the surface but still exist. Also, the characteristics of CCPs are changing. The expanding central clearing model makes them systemically even more

important. Additionally, competitive forces are getting stronger. Many CCPs' origin is that of a public utility whereas currently they play a key role in the competitive landscape of market infrastructures. In the EU we have significantly strengthened the regulation and supervision of CCPs to ensure their resilience. However, we also need a CCP recovery and resolution regime to cope with losses generated by severe, unpredictable market developments beyond extreme but plausible market conditions, including the default of more than two of the largest clearing members.

CCP recovery and resolution for severe, unpredictable market developments

As we heard in the second panel discussion today, despite enhanced supervisory requirements of CCPs, we cannot exclude the possibility that CCPs are faced with higher losses than those envisaged under extreme but plausible market conditions and that they may even default under severe, unpredictable market developments. Therefore, recovery and resolution plans should be in place in order to ensure the continuity of critical services provided by systemically important CCPs. We need to put the lifeboats in place.

Thus, it is of primary importance that CCPs develop their recovery plans and they should do that in line with international standards. Some EU CCPs have already presented a recovery plan to their competent authorities. Others are in the process of doing so. Although under EMIR there is no requirement for CCPs to develop recovery plans, I would like to recall that in September 2014 ESMA adopted Guidelines and

Recommendations regarding the implementation of PFMI in respect of CCPs. As the PFMI contain provisions requiring CCPs to develop recovery plans, ESMA urges EU CCPs to also comply promptly with these provisions. They should do this in line with the guidance provided in the 2014 CPMI-IOSCO report on the recovery of FMIs.

Besides CCP recovery plans, there is also a role for public authorities to intervene when CCPs cannot achieve recovery alone. When recovery plans fail, resolution authorities should be established to ensure the continuity of critical services for the stability of financial markets. ESMA appreciates the guidance provided by the FSB in its 2014 report on the key attributes of an effective resolution regime for financial institutions, and strongly supports the implementation of resolution regimes for CCPs.

What resolution tools for CCPs?

Looking forward I am particularly interested in learning what resolution tools will be available to a resolution authority under the new EU regime. We will learn more from the next panel discussion about resolution tools and how they can preserve financial stability.

CCPs do not perform banking activities and are not even allowed to perform such activities. It would therefore be a mistake to copy blindly the CCP resolution regime from the bank resolution regime. CCPs have different functions, different risks, different balance sheet structures and very different interdependencies with other infrastructures. For instance, tools relying on the closure of critical services or the issuance of contingent convertible bonds are not suitable for the resolution of CCPs. Likewise,

elements that in bank resolution are essential, like valuation of assets, are pretty straightforward in CCPs, which value daily the liquid derivatives or securities they clear. Equally, where subordinate debt haircutting is important for bank resolution, it is fairly irrelevant in the CCP world due to the different structure of their funding.

In my view, CCP resolution tools should aim to preserve the continuation of critical services while redistributing losses to the CCP's shareholders and/or user community. In general, I believe that resolution authorities should have discretion to select the resolution tool to apply in a given scenario from the widest possible list: it is better to have one extra tool in the authorities' toolkit than one less. Where tools have a significant impact on the overall market, and CCP clearing members and their clients, additional safeguards and further scrutiny can be introduced before they are used. Hence, the solution should not simply be to eliminate them from the list of eligible tools.

This is particularly the case for initial margin haircutting. I am of the view that this tool should not be excluded a priori but seriously considered as a last-resort resolution tool after all other resolution tools have been exercised. However, haircutting of initial margin should ensure that the residual initial margins are still compliant with EMIR requirements. If an initial margin haircutting resulted in a margin call the day after resolution, it would be more advisable to consider a cash call in resolution. Should initial margin haircutting be used, my view is that this should apply to both clients and clearing members in order to avoid altering market structures in favour of indirect clearing.

Similarly, I am of the view that any use of pre-funded resources available in any non-depleted default funds could be considered up to amounts in excess of minimum regulatory requirements under EMIR, in order to avoid the need of any further call for contributions the day after resolution.

Resolution tools may differently affect the interests of the impacted parties across the jurisdictions involved in the resolution of CCPs with cross-border interdependencies. I believe that resolution authorities should have discretion in applying the resolution tools in a specific scenario. However, it is key that the resolution strategy and plan is agreed among the relevant authorities from the jurisdictions involved. Therefore, ESMA welcomes the establishment of Crisis Management Groups envisaged by the FSB's key attributes in order to facilitate the necessary cooperation among the authorities involved. I will therefore listen with interest to the debate on International Cooperation and Democratic Accountability in today's last panel.

The EU regime for CCP recovery and resolution

Let me conclude my speech by saying a few words on the new EU regime for recovery and resolution for CCPs. As you all know, the European Commission is expected to present its proposal for this regime by the end of this year. I fully understand that the timeline of this proposal has been revised in order to take into account the result of further international work on CCP recovery and resolution by CPMI-IOSCO and the FSB. I look forward to reading the new legislative proposal.

I understand that the new legislation will provide for common principles on recovery and resolution plans, without prescribing what recovery or resolution tools should be included in either plan. I believe though that Regulatory Technical Standards (RTS) should define the recovery and resolution tools that CCPs and resolution authorities should consider and, eventually, establish a sequence for use of those tools.

Concerning the institutional set up for CCP resolution authorities in the EU, an EU level resolution authority could resolve any conflicts of interests between domestic resolution authorities versus foreign relevant authorities representing the interests of non-domestic users. However, I fully recognise that such an approach is not consistent with the current arrangement where CCP supervision is conducted at national level.

Therefore, taking as the baseline that resolution powers are assigned to national authorities, in my view resolution colleges should be established mirroring the existing supervisory colleges. This will facilitate the coordination and cooperation among the relevant authorities across the EU. The new EU legislation should thus clearly assign roles and responsibilities of both resolution authorities and resolution colleges, regarding preparing the resolution strategy and plan, deciding on the entry into resolution and early interventions, and exercising resolutions tools. In particular, in order to ensure an efficient functioning of resolution colleges, it is important to limit participation to the most relevant authorities affected by the resolution of a CCP.

In the past years, ESMA has built up extensive experience with regulation, consistent supervision, coordination and mediation in the area of CCPs. Therefore, ESMA stands ready to play a role in the field of recovery and

resolution of CCPs under the upcoming new EU regime. We look forward to cooperating closely with the resolution authorities under the new EU legislation. In the meantime, ESMA also stands ready to contribute to any upcoming debate on the finalisation of the EU legislation and the drafting of any technical standards complementing the new legislation.

Let me finally go back to my earlier remark when I compared recovery and resolution arrangements with life boats. I should mention that a life boat plays an important role in one of the scenes of the well-known comedians Monty Python. While the scene starts off as quite nasty with a debate who should eat who, ultimately it has a happy ending with a good dinner. Let's keep that in mind when making recovery and resolution plans for CCPs.

Thank you for your attention.