BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

1 June 2011

Clearing houses as system risk managers - speech by Paul Tucker

In a speech at the launch of the Depository Trust & Clearing Corporation (DTCC) - Centre for the Study of Financial Innovation (CSFI) Post-Trade Fellowship, Paul Tucker – Deputy Governor for Financial Stability, member of the Monetary Policy Committee and member of the interim Financial Policy Committee – discusses the crucial role central clearing parties (CCPs) play in the financial system and makes several recommendations on how they can better contribute to preserving stability. In order to perform their multiple tasks, CCPs should do the following: a) regard themselves and act as system risk managers; b) avoid heavily procyclical margining policies; c) monitor the soundness of their clearing members and the risks they bring to the CCP. He calls for debates on whether clearing houses should set margin requirements on a gross basis rather than net; whether macro-prudential authorities should vary minimum margin requirements over the cycle; and on the development of an ex ante resolution framework for limiting disorder if a CCP were ever to fail.

He begins by explaining how CCPs simplify the complex web of counterparty exposures by acting as counterparty for all the trades they clear. This means that they have to manage significant exposure to counterparty credit risk. In this way, CCPs' roles extend well beyond acting simply as a provider of operational and capital efficiency for clearing members: "They are de facto regulators and supervisors for the markets they clear; and risk managers of their own balance sheet. In protecting themselves, they impose some financial discipline on their clearing members." To underpin CCPs' responsibilities as risk managers, Paul Tucker encourages them to monitor the robustness of their clearing members and of the businesses these members bring to CCPs which would raise awareness of any fragilities – "I am not convinced that that is sufficiently recognised by clearing houses or by standard setters," he says.

Turning to design issues that ultimately could simplify the chain of credit in cleared trades and reduce leverage in the system, Paul Tucker states that the authorities and clearing houses should consider whether to adopt Gross Margining, in which a clearing member cannot net off the positions of their customers and their own house position when the amount of margin they have to hold with the clearing house is determined. Such an approach affects the incentives of clearing members to collect minimum margin amounts from their customers. In discussing these issues, Paul Tucker highlights several examples of clearing house failures in recent decades, including Caisse de Liquidation in Paris, the Kuala Lumpur Commodities Clearing House,

and the Hong Kong Futures Exchange – and argues that, given the systemic nature of clearing houses, such scenarios should never be repeated. As well as minimum standards to guard against failure, the system needs a “clear ex ante framework...for limiting disorder” if a CCP does ever fail. A CCP resolution could involve either ‘recapitalising’ the CCP or unwinding the CCP’s transaction book. Paul Tucker concludes: “Maybe I’ve got this wrong but, in summary, its seems to me that questions about orderly resolution of a failed CCP have to involve clarity around the extent to which surviving clearing members pick up the pieces...The design, management and oversight of CCPs is something that we are going to come back to again and again in the years ahead.”

Key Resources

Clearing houses as system risk managers – Full speech