BANK OF ENGLAND

Speech

Central counterparties: the agenda

Speech given by

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Thank you very much for inviting me today. The map for post-trade infrastructure is being redrawn, here in the EU, in the US, and in Asia, under the policies of the G20 and Financial Stability Board. This renewed focus on the plumbing of the financial system is welcome to central bankers.

I should like to make just four points[1]. All starting from the proposition that the safety and soundness of central counterparties (CCPs) is absolutely vital to preserving stability in global capital markets.

(1) Organisational structure

Some years ago, there was a debate about whether the authorities should favour 'horizontal integration' or 'vertical integration' of trading, clearing and settlement infrastructure. Events have taken their course, and vertically integrated groups – concretely, of exchanges owning clearing houses – have become commonplace.

The authorities need policies to address this. One dimension is competition. The Commission are focussed on that.

In terms of financial stability – my own focus – it is vital that the risk manager in the CCP, which means the heart of the CCP, should have a clear and independent line to the group board, so that they cannot be lent on by the affiliated exchange to reduce or shade initial margin requirements or collateral terms or portfolio investment policies in order to generate more turnover. This will matter more than ever during a period in which there is likely to be more than one CCP clearing some markets.

In the same spirit, the core risk management functions of CCPs should not be outsourced. Regulators have been slow to embrace this. But I am glad to say that it does get some recognition in the EMIR text, perhaps not as unambiguously as is warranted in my view.

(2) Global CCPs and access

The efficiencies and risk management advantages of multilateral netting across a variety of products make it likely that the world will have a few global CCPs. There must be broad access to these CCPs, provided always that that can be made consistent with maintaining the integrity of risk management (including default procedures). The benefits of putting over the counter (OTC) derivatives trading through CCPs cannot be confined to a few currencies or markets. That is not what the G20 mandated; and, in any case, it would not be in the interests of global stability.

Related to all this, the EU must ensure that requirements to clear through CCPs apply also to exchange-traded derivatives and to vital cash markets, not just to 'standardized' OTC derivatives. Whatever anyone says, there is

[1] Thanks for comments to Andy Haldane, Edwin Schooling-Latter, Anne Wetherilt, Graham Young and David Lawton (FSA).

really no excuse for where things currently stand on this in Europe. The MIFID II package provides an opportunity to correct it next year. Those who argue that the gap in the EU's framework should persist are serious about private gain but, sadly, not about stability. The crisis that threatens to engulf us all illustrates why we should give no room to such sentiments.

(3) CCP default and resolution

There is a big gap in the regimes for CCPs – what happens if they go bust? I can tell you the simple answer: mayhem. As bad as, conceivably worse than, the failure of large and complex banks[2].

We therefore need effective resolution regimes for CCPs (and other financial market infrastructure). The Financial Stability Board will drive this forward as part of our work on the resolution of SIFIs. (A comprehensive package on the resolution of banks and dealers will go to the G20 Leaders Summit shortly. If endorsed, and Finance Ministers have already given their endorsement, it will become a Standard to which countries/jurisdictions pledge to abide.) The EU's own work on resolution regimes has been a hugely positive input to this global process.

As part of the FSB-led and co-ordinated effort, the central bank Committee on Payment and Settlement Systems and IOSCO are beginning to work on this area of resolution. They must make a clear distinction between measures to procure, on the one hand, Recovery from distress and, on the other hand, Resolution. Orderly resolution is what is needed when a CCP is bankrupt, when we all need somehow to avoid the chaos that follows a standard liquidation of assets and closing out of positions.

The issue, always, is where do the losses go? The answer cannot be the taxpayer. In the banking sphere, the answer, broadly, is bond holders and other unsecured, uninsured creditors. In the CCP sphere, it is probably the clearing members, as they would be the principal creditors in an insolvent liquidation. The technical issue is how to achieve that in a way that minimises disruption and value destruction and enables essential CCP services to be maintained. This is a key agenda item going forward. It will involve achieving greater clarity in the related area of the optimal 'waterfall' of margin, default fund and CCP own-capital resources in absorbing losses.

(4) Margin requirements and macroprudential policy

Earlier this year, US Treasury Secretary Geithner called for the world's major financial authorities to agree minimum initial margin requirements for uncleared OTC derivative contracts, on the grounds that we must avoid a race to the bottom and incentives that make it attractive to clear bilaterally rather than via a CCP. I agree.

[2] See Tucker, P M W, 'Clearing houses as system risk managers', June 2011.

But, looking ahead, we must surely establish a system that can extend beyond that ‘first base’. First, we need policies that extend across markets. If we apply them only to OTC contracts, exchange-traded contracts might be subject to different requirements. And if we applied such minima only to, say, futures, we could see the economic substance of futures synthesized via cash repo markets on looser terms. The same applies to other products and markets. Generally, we should take care to avoid regimes that give market participants incentives to chose between economically equivalent transactions and post-trade processing on the basis of different margin or haircut requirements.

Secondly, we have to recognise that economic and financial conditions change – sometimes beyond our wildest dreams – so any minima set for one period may not be at all suitable for another. We need, therefore, to be able to vary any such minima as threats to stability evolve (crudely, cyclically).

You will recognise in this an echo of the plans for varying bank capital requirements. This is all part of an evolving macroprudential toolkit. As a contribution to that, EMIR should make explicit provision for macroprudential tools. The initial text did not do so, I think mainly because macroprudential thinking has been advancing as the crisis has evolved, but I understand that the Parliament’s text does take a step in this direction. It is not too late for Europe to lead the world in this area on macroprudential policy generally, by providing a framework for national regimes co-operating with ESRB and, where relevant, the ESAs.

Thank you.