



BANK OF ENGLAND

Speech

The Bank of England's perspective on CCP risk management, recovery and resolution arrangements

Speech given by

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Good morning. First of all, let me start by thanking the team at Eurex for inviting me to speak here today.

This conference comes at a very timely point, just over five years on from the G20 summit in Pittsburgh that placed such a significant focus on central clearing. In the EU we also have a new Commission settling in and so it seems an appropriate juncture at which to reflect on the progress of the last five years and the challenges that lie ahead.

I think we can all agree that the G20 mandate to centralise the clearing of standardised OTC derivatives has increased the systemic importance of CCPs; I will even borrow a phrase I have heard one of my fellow speakers use previously to note that CCPs are emerging as “super-systemic” institutions, with increasing importance across multiple jurisdictions.

It is also clear that, recognising this, the international community has made very significant and tangible progress to ensure that CCPs are being held to higher risk standards and regulatory expectations.

As the supervisor of some of the largest CCPs, which clear securities and derivatives denominated in over seventeen currencies across the globe, the Bank of England has been heavily engaged in the international efforts to promote the right standards and expectations of CCPs, and also to ensure that they are implemented in practice.

But it is important to recognise that we have not reached the end of our journey – more can, and must, be done.

I will therefore outline my views on the progress made to date, internationally and within the UK, to develop and strengthen:

1. Risk management standards at CCPs;
2. CCP recovery arrangements; and
3. Resolution tools for CCPs.

It is critical that we maintain our momentum in these areas and I will highlight the key points of focus from my perspective.

In particular, further progress is needed to ensure that recovery and resolution regimes are robust, credible and well understood so that they can be used to successfully minimise the impact of a failing CCP on financial stability.

Robust risk management standards

Let me start with the first area: CCP risk standards. Robust risk standards, implemented consistently across jurisdictions are clearly essential to ensure that CCPs deliver the outcome that we, and the G20, expect of them. That is to safeguard the financial system through the effective management of counterparty credit risk.

Internationally, the 2012 CPMI-IOSCO Principles for Financial Market Infrastructure, as implemented within the EU by EMIR, have represented a significant step forward, resulting in more rigorous expectations of CCPs across their business and including important areas such as counterparty, liquidity and operational risk management.

Within the UK, the PFMI form a key foundation stone of the Bank of England's supervisory approach and our regulatory framework is consistent with these standards. As part of our approach, we require CCPs to complete annual self-assessments against the PFMI which provide an effective test of the CCPs' implementation of, and commitment to, the standards the international regulatory community has set.

Furthermore, and recognising the importance of UK-based CCPs across multiple jurisdictions, we have placed the PFMI 'Responsibilities' on international co-operation at the heart of our supervisory approach. Making regulatory cooperation effective between the relevant regulators of CCPs is a priority for the Bank as our CCPs perform important activities for firms and markets in the EU, US and globally.

For that reason, we operate regulatory colleges for UK CCPs at both the EU level, as mandated by EMIR, and globally. These arrangements are important in allowing us to inform our international counterparts of developments at UK CCPs, and to benefit from their valuable input, expertise and experience in supervising CCPs and firms in many other jurisdictions. Our experience is that the supervisory expertise brought together through these arrangements means that colleges can be greater than the sum of their parts. We see this collegiate model as an effective template for all CCPs that operate on a multi-jurisdictional basis and we advocate the use of such arrangements more widely.

Whilst the PFMI have taken us a long way, we do not believe that they represent an end-point to our regulatory journey; rather they must be viewed as a very useful baseline that must continue to evolve and develop to continue to provide for effective CCP risk management.

Indeed, we have already identified areas in which the international standards could benefit from additional guidance, which will be important to ensure robust and consistent interpretation and implementation across the G20, particularly with regard to counterparty credit risk standards.

For example, one clear area of the current international standards that could be further developed to strengthen CCPs' counterparty credit risk management relates to stress testing requirements. Whilst the

PFMIs and EMIR do require an appropriately and prudently sized default fund, there is no requirement for CCPs to disclose the details of the stress tests which they use, which ultimately determines the size of these default funds. Therefore it may be difficult for participants to fully compare the level of stress that CCPs can withstand.

Furthermore, we would welcome the development of standardised approaches to designing stress scenarios, which could include standardised regulatory stress tests for CCPs as we have seen in the banking sector. However it is crucial for these to be set in context. Standardised stress tests must be well-designed to incorporate the diversity of business models of CCPs globally. And more importantly, they could only be viewed as 'minimum' stress tests, which would complement more tailored and potentially much more rigorous internal stress testing, developed and implemented by individual CCPs.

The last thing I will say on CCP risk standards is, however, that a consistent regulatory framework is not enough.

Ensuring CCPs are robust and resilient relies on a joint effort from regulators, the CCPs and their users alike. We, and I stress we, must hold the CCPs to the highest risk standards.

In this regard, we welcome the forthcoming guidance from CPMI-IOSCO on public quantitative disclosure standards for CCPs, which will represent a step in the right direction to put clearing members and participants in a better position to use only those CCPs that are sufficiently well risk managed, not simply those that are the most cost-effective. Clearing members must stand ready to justify their choices to regulators and other stakeholders on request.

CCP recovery arrangements

Now I will turn to recovery: what happens in the event that a CCP's pre-funded resources are not sufficient?

No matter how strict the regulations are, or how good a CCP's risk management is, the possibility of an extreme event, one that we might even consider implausible, that causes financial distress or failure is something that we cannot and indeed must not ignore. Supervisors need to carefully consider what actions a CCP could take to maintain its economic viability whilst also continuing to provide its critical clearing services.

The Bank of England therefore welcomes the recently published CPMI-IOSCO report on recovery of FMIs which provides clear guidance to CCPs on how to answer this very important question and develop their own recovery arrangements. Potential tools identified in the report include "assessment rights", that is, the right to call for additional resources from members, variation margin haircutting and, ultimately, contract termination, or 'tear-up'.

Within the UK we have already required CCPs to prepare recovery plans and introduce arrangements to allocate extreme losses. This means that they have put in place loss-allocation arrangements to meet uncovered losses arising from a clearing member default, and for non-clearing member default losses that could threaten solvency.

From our domestic experience, we know that there is no “one-size-fits-all” recovery plan. Plans must take into account the specific CCP, the nature of its products and the markets in which it operates. This is reflected in the approaches the UK CCPs have taken in developing their own recovery arrangements.

These arrangements will continue to be developed and fine-tuned in response to the rigorous periodic tests that the CCPs will undertake and arrangements may need to be updated as clearing services, CCP participants and central clearing mandates evolve. We will also consider whether UK CCPs need to make any more changes to bring them in line with the recently published CPMI-IOSCO guidance.

One point that I will emphasise is that there is the potential for CCPs to suffer losses, or even fail, for reasons other than member default. For instance, a CCP could incur losses on its investment policy or through operational issues. Despite the strict requirements in EMIR and the PFMI that reduce the probability of this failure, there is still a tail risk that these could create uncovered losses that would exceed the CCP’s capital. Therefore, CCPs, together with their clearing members and regulators, must consider the recovery tools that they would employ if a non-default loss depletes the CCP’s capital.

It is, however, important that recovery arrangements do not dis-incentivise effective management by CCPs of their non-default risks. CCPs should bear at least the first tranche of the loss with an amount of their own capital providing a clear incentive to prudently manage these risks.

Finally, however a CCP decides to implement its recovery plan, it must properly disclose information on the risks and liabilities that its clearing members will face *in extremis* so that its participants can truly understand and manage the risks and properly scrutinise the CCP’s management of these risks. This is in line with CPMI-IOSCO guidance, and reinforced via our supervisory approach.

CCP resolution tools

The final question I will touch upon today is: what would happen if it appears likely that a CCP’s recovery plan will not work in practice; or if a CCP can only remain viable by taking actions that could undermine wider financial stability?

A CCPs’ risk management should be prudent and robust, and its recovery plans should be designed to be fully comprehensive and effective. However, it is incumbent on us, as authorities, to consider what happens if they are not. In this case, resolution authorities will need to step in with effective and comprehensive

stabilisation powers to act as a final backstop; and to provide continuity to the CCP's critical economic functions, whilst providing an orderly wind-down for any non-systemic operations.

The UK has been at the forefront of developing thinking around the appropriate resolution tools for CCPs. Earlier this year we put in place a domestic resolution regime for our UK CCPs. This is a significant step forward which provides the Bank of England, as resolution authority, with some of the tools necessary to facilitate the resolution of a failing CCP.¹

We welcome the recently published annex to the FSB Key Attributes on resolution and we aim to further develop our domestic resolution regime to bring it in line with these international standards. We anticipate achieving this via the forthcoming European legislative proposal on CCP resolution which we expect to be proposed next year. Ensuring that we, and other resolution authorities, have a comprehensive set of tools to effectively resolve a CCP will be a clear priority for that legislation.

In my view, an effective resolution regime must offer national resolution authorities flexibility to assess the specific circumstances of a CCP's failure and to react in the most appropriate manner to protect financial stability. To do this, resolution authorities must be able to act in a timely and forward-looking way, even potentially before recovery actions have been exhausted, and with a variety of tools, to respond to the specific nature and cause of the CCP's business failure.

However there is, of course, a trade-off between resolution flexibility and ex-ante transparency for CCP participants. To alleviate this concern, participants should be given reassurance that any resolution actions would be accompanied by relevant safeguards, including a No Creditor Worse Off safeguard, which would limit the individual losses to the losses they would experience in insolvency. This should provide some degree of ex-ante transparency about the size, but perhaps not the exact form, of the loss.

The next obvious question is: what tools should this legislation provide?

Here we can be informed by the experience of developing the European Bank Recovery and Resolution Directive (BRRD).

In my view there should be a flexible resolution toolkit for CCPs. In particular resolution authorities need the power to recapitalise a failing CCP in a timely manner including through writing down liabilities and converting them to equity. Existing shareholders should be the first to bear the losses if this approach is to be taken.

¹ To resolve a failing CCP through the transfer of property to either a private sector purchaser or to a bridge CCP owned by the Bank of England, or to transfer ownership of a CCP to any person

There is also an important question as to whether CCPs are resolvable in their current forms, and within that, whether changes to the liability structure of CCPs are necessary to make this approach credible, without recourse to taxpayer funds. The FSB has recently proposed that there must be a minimum level of “Total Loss Absorbing Capacity”, for banks and we will need to consider carefully whether and how this concept could be effectively translated to CCPs. In a similar vein, writing down operating liabilities through some form of initial margin haircutting should also be considered.

There may, of course, be other solutions, and the legislative proposal should consider a full suite of tools to ensure that the CCP resolution regime can be timely, credible, well-understood and effective.

Finally, one important point that an effective resolution regime must address relates to information sharing.

To ensure that resolution plans are practicable and timely, resolution authorities must communicate and cooperate with other resolution authorities and relevant regulators, through Crisis Management Groups or other similar arrangements, to explain what specific plans and tools would be adopted for each CCP in a non-exhaustive range of crisis scenarios, as has already been done by banks. Given the increasing importance of CCPs across jurisdictions, this active international cooperation and engagement is essential and we are actively considering how to embed this alongside the college arrangements for UK CCPs that I referred to earlier.

Conclusion

So to conclude – we have made real progress since 2009 to increase CCP risk standards and to ensure these have been implemented effectively. However, we must regularly take stock of the standards to ensure that they keep pace with market practices as they evolve, and to ensure that the standards are being implemented consistently internationally.

Furthermore, CCPs, their users and their regulators must not ignore the possibility that, despite these risk standards, a CCP could get into financial distress. CCPs must therefore put in place well-considered and appropriate recovery arrangements and resolution authorities should be provided with a full suite of tools that will deal with the unique risks posed by CCPs.

These are necessary steps in promoting the G20’s objectives with respect to central clearing in a manner consistent with an objective to promote financial stability. Good progress is being made and, recognising the importance of the CCPs that we supervise within the UK, we are committed to playing a leading role in taking these steps.

Thank you.