



BANK OF ENGLAND

# Speech

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## **Central clearing: setting the regulatory bar**

Speech given by

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I would like to thank Tim Rawlings for his contribution to this speech.

Good afternoon. First of all I would like to thank the team at Futures and Options World for inviting me to speak to you today.

It will not be news to this audience that the 2009 G20 commitments on OTC derivatives triggered a sea change for derivatives markets. After all, the key pillars of these commitments around central clearing, organised trading, reporting to trade repositories and capital requirements for non-cleared trades represent a cornerstone of the post-crisis reform agenda.

Today I want to talk to you about the first pillar, central clearing.

A clear intent of the reform agenda has been to transfer risk from bilateral arrangements into central counterparties (CCPs) where it can be netted, better managed and made more transparent. Accordingly CCPs are expected to meet very high regulatory and risk management standards. But this also has clear consequences for the importance of CCPs within the financial system as we have noted in recent Financial Stability Reports.<sup>1</sup> I increasingly hear CCPs being described as 'super-systemic' or 'the new 'Too Big To Fail'.

It is right, therefore that we take stock of the extensive work that has been undertaken domestically and internationally, led by the Financial Stability Board (FSB), to deliver a robust regulatory regime for CCPs; but also to recognise that areas exist where more work is required by the regulatory community, CCPs and their members to ensure we have the right tools to address the risks posed by the increasing importance of CCPs.

Indeed it is an opportune moment to do so. As of the end of 2015, over half of the \$384tn global OTC interest rate derivatives market was centrally cleared and over one fifth of the \$12tn credit derivatives market was centrally cleared.<sup>2</sup> The proportion of derivatives being centrally cleared can be expected to increase significantly following the introduction of the EU's first mandatory clearing obligations starting in June, and we expect to see the same trend for other asset classes.

I will therefore use my time with you today to reflect on:

- the achievements to date in strengthening the regulatory and supervisory framework for CCPs;
- the challenges that remain, which include the implementation of effective recovery and resolution regimes for CCPs; and,

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<sup>1</sup> For example see December 2015 *Financial Stability Report*, page 51, available at <http://www.bankofengland.co.uk/publications/Documents/fsr/2015/dec.pdf>

<sup>2</sup> Market size is estimated by outstanding gross notional value. See Bank for International Settlements (2016), 'Statistical release; OTC derivative statistics at end-December 2015', available at [http://www.bis.org/publ/otc\\_hy1605.pdf](http://www.bis.org/publ/otc_hy1605.pdf)  
The proportion of centrally cleared trades is based on Bank calculations using trade information reports from DTCC. See Bank of England (2016) 'The Bank of England's supervision of financial market infrastructures – Annual Report' page 18, available at <http://www.bankofengland.co.uk/publications/Documents/fmi/annualreport2016.pdf>

- the actions the Bank of England (“the Bank”) along with the regulatory community is taking to address these challenges.

### **We have come a long way since the 2009 G20 Pittsburgh statement...**

To start with, I want to recognise some of the principal actions taken to date to strengthen the resilience of CCPs.

In 2012 CPMI-IOSCO issued the Principles for Financial Market Infrastructure (“the Principles”). These represented a major strengthening of the regulatory standards for CCPs, requiring the largest CCPs to be able to withstand multiple member defaults in highly stressed markets. They have led to a material enhancement in risk management and governance as well as substantially increased the financial resources held by CCPs.

In the EU the Principles lie at the heart of the EMIR legislation and form the bedrock of the Bank of England’s supervisory approach. CPMI and IOSCO undertake implementation monitoring reviews to assess compliance with the Principles.<sup>3</sup> I am pleased to say that the UK, which is home to some of the world’s biggest and most systemically important CCPs, has been deemed fully compliant; including in the way it cooperates with other international authorities through our colleges of regulators. However, this is not the case for all jurisdictions, and this is something which the relevant authorities should address.

But whilst focusing on the resilience of CCPs is a necessary first step, on its own it is not sufficient. As authorities with responsibility for the stability of the financial system, we need to plan for the extreme or even the implausible event. This means aiming to ensure that, in a stressed scenario, CCPs can replenish their financial resources and can continue their role as systemic risk managers, or, if necessary, resolution action can ensure the continuity of critical economic functions. Simply put, we need to ensure that CCPs are not ‘Too Big Too Fail’.

Therefore in 2014 the Principles were complemented by the CPMI-IOSCO guidance on the Recovery of Financial Market Infrastructures which sets clear standards for how CCPs should develop their recovery plans. Further, in 2014 the FSB also published a new Annex to the Key Attributes of Effective Resolution Regimes, which sets out how those international standards apply to market infrastructure, and in particular CCPs.

The UK has led the way in introducing legislation requiring CCPs to maintain recovery plans and all UK CCPs now have these arrangements in place. The UK has also legislated to extend its resolution regime to

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<sup>3</sup> For more information see [http://www.bis.org/cpmi/info\\_mios.htm](http://www.bis.org/cpmi/info_mios.htm)

CCPs recognising the need to reduce reliance on public funds as a back stop in the event of a CCP failing and has been the first to form a Crisis Management Group to facilitate the resolution planning of a CCP.

**...but there is still more to do**

Whilst this represents a huge amount of work, it is clear that more needs to be done to address the risks posed by the increasing systemic importance of CCPs. Internationally this is being coordinated by a joint workplan on CCPs<sup>4</sup> which forms one of the key priorities for the FSB, the BCBS, CPMI, and IOSCO through 2016 and beyond.

The workplan covers four areas. Firstly, identifying areas where regulatory standards should be enhanced to make CCPs even more resilient. Secondly, assessing the adequacy of guidance around CCPs' recovery plans. Thirdly, developing a credible resolution framework and ensuring that CCPs are resolvable. Fourthly, obtaining a more thorough understanding of the inter-dependencies between CCPs and their users.

It is very fitting that these elements sit side-by-side in the workplan. We do not see them as isolated topics but as a continuum of issues designed to help deliver the G20 commitments. And for those of you in the audience who may be thinking that this speech only applies to CCPs themselves but not their users then please think again. A CCP's users are directly exposed to the CCP's resilience and have an incredibly important role to play in holding it to the highest risk management standards. Your input into the development and implementation of the next stage of the CCP framework will be vital in ensuring it is comprehensive, practical and proportionate.

*Resilience*

I will take the four areas of the CCP workplan in turn, starting with resilience.

Clearly, resilient CCPs underpinned by a robust regulatory and supervisory framework are imperative to deliver the G20 commitments. The Principles have delivered a material improvement in risk management standards, but implementation has also revealed areas where further guidance may be necessary. Two areas I will highlight are stress testing and margin methodologies.

A robust stress testing framework is vital for a CCP as it is the critical input in determining the financial resources it needs to hold in order to withstand the default of its major participants in 'extreme but plausible' conditions. While the Principles outline the need for CCPs to regularly test the sufficiency of their financial resources for both credit and liquidity risk, in the Bank's view additional granularity is needed to set out what

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<sup>4</sup> For more information see FSB, BCBS, CPMI and IOSCO (2015), '2015 CCP Workplan', available at <http://www.fsb.org/wp-content/uploads/Joint-CCP-Workplan-for-2015-For-Publication.pdf>

stress testing should incorporate and how it should be conducted, in order to ensure consistency of approach across CCPs internationally.

Greater transparency over the relative robustness of CCPs is important for both regulators and the market. However, no two CCPs are exposed to the same sources of risk. Therefore to complement CCPs' own stress tests it is also important that authorities explore how standardised stress tests could be developed across multiple CCPs both domestically and internationally. However, this is a much easier task to talk about than to conduct and will necessarily differ from the framework used to stress test banks. Initial steps have been taken via a joint default management exercise run by the UK and German authorities across two of our major CCPs, and ESMA has recently published the results of its first EU-wide stress test of CCPs. In our view, it is important that work is progressed at the international level to provide consistency. Given the importance of UK CCPs in global markets, the Bank looks forward to making a major contribution to this work.

At the core of a CCP's risk management are its initial margin models which set the amount of margin held as a first line of defence in the event of a member default. The proper design and calibration of these models is therefore essential.

Whilst, in general, margin models are well developed, there remain areas where greater regulatory guidance could be given to ensure international congruence. A particular focus should be to ensure that models provide for sufficiently stable and conservative margins over time and do not lead to rapid changes in stressed conditions because margin levels have been allowed to fall too low in benign times. Given the recent agreement between the CFTC and EU on a common approach to the supervision of CCPs, consideration should also be given to whether a standardised minimum margin period of risk should be embedded within the Principles.

### *Recovery*

Turning to the second area of the CCP workplan, recovery.

The Principles and the supplementary guidance on recovery set out the standards for recovery planning by CCPs. Whilst the UK has implemented the guidance; a priority is now for the CCPs and their regulators, in jurisdictions that have not yet done so, to implement these standards.

Our experience of implementing recovery plans in the UK has taught us that there is no single template for CCP recovery plans. Each CCP must develop a recovery plan which takes account of the products it clears, the make-up of its membership and the risk factors it is exposed to, and ensure that its recovery plans do not dis-incentivise proper governance and risk management. It is also important that the tools employed in

recovery carefully consider the impact on members and provide clarity and transparency over when additional financial resources will be called from members.

As part of the international workplan on CCPs, a CPMI-IOSCO consultation paper is due this summer which will tackle many of these questions on CCP resilience and recovery and I encourage you to engage with it.

### *Resolution*

The third topic I will cover is resolution, which is the aspect of the CCP workplan that has increasingly generated debate, but before 2016 was probably the least advanced.

It is, however, a crucial part of the continuum needed to form a coherent regime for CCPs. The objective of the resolution framework should be to ensure the continuity of a CCP's critical economic functions with minimum impact on the wider financial system and without relying on public funds. Establishing a credible resolution framework also reinforces prudent risk management and aligns the incentives of clearing members to engage with recovery actions.

The biggest CCPs operate internationally and their failure would have an impact across a range of jurisdictions. Therefore, the Bank is a strong supporter of international efforts to establish a coherent and consistent approach to CCP resolution which ensures a level playing field. This is particularly important as the EU Commission is developing its own legislative proposal on the recovery and resolution of CCPs but helpfully to a timetable which is designed to allow an international framework to be developed. A repeat of the protracted equivalence discussions we have seen under EMIR would not be helpful.

There are a number of fundamental questions that regulators globally need to tackle to develop a framework. I will highlight three.

- First, at what point should a resolution authority step in when a CCP is in distress?

In our view this should be designed to allow recovery actions a clear chance of success, but also be early enough for a resolution authority to deliver an effective resolution. Setting clear expectations and providing transparency on this will be important to inform planning by CCPs and their members.

- Second, what resources should be available to the resolution authority and should these be pre-funded?

It is clear that a resolution authority needs to have financial resources available to it at the CCP to absorb losses and to replenish the CCP's default waterfall, but which have not already been exhausted in unsuccessful recovery efforts. Without these we would effectively be handing a resolution authority a

'hospital pass' with limited tools to discharge its mandate. But the cost of these resources to a CCP's users has to be proportionate and also continue to incentivise prudent risk management in the clearing process.

Our view therefore is that the resources reserved for resolution authorities can be based on a CCP's existing default waterfall and made available to the resolution authority where resolution is deemed necessary, and to the CCP at the discretion of the resolution authority where it is not. This would have the advantage of helping establish clear and strong expectations as to the course a resolution authority would take in allocating losses and replenishing a CCP's resources; but that this could be based on the CCP's rules and also avoid the need for, and cost of, additional pre-funded resources. Although, while the goal should be a clear presumption of the path a resolution authority would follow, I note that the authority must ultimately retain a degree of flexibility to diverge from the expected path should it consider it necessary in pursuing its objectives.

- Third, what safeguards need to be put in place for clearing members of CCPs and their direct and indirect clients?

On this question it is critical that there are clear and credible safeguards for CCPs, their members and clients. This includes the 'No Creditor Worse Off' principle. But 'No Creditor Worse Off' needs to be considered in the context of CCP default management and recovery plans, and considerations around how it would be applied may differ from a bank in resolution.

The FSB has stated it will consult later this year on further guidance on strategies and tools for CCP resolution.

#### *Inter-dependencies of CCPs*

The final part of the workplan is to analyse inter-dependencies between CCPs and their major participants.

This work should support the other strands of the CCP workplan by providing greater clarity on the systemic position of CCPs. In addition it should support the design of supervisory stress tests by providing information on the nature and significance of the links between CCPs and other parts of the financial network; it is ultimately the resilience of this financial network that we wish to subject to stress tests.

Taken together the workplan represents a comprehensive set of steps to take the regulatory framework for CCPs to the next level, a process in which the Bank is fully engaged.

## Conclusion

To conclude, CCPs are a crucial part of the post crisis reform agenda and, as a result, their importance has increased significantly. We therefore need to make sure they are robust, that the chance of them failing is minimised and that authorities have the tools available to pursue the objective of achieving continuity in their critical functions if they do experience distress.

Substantial progress has been made but we still have some distance to travel including by:

- Making CCPs more resilient through more granular guidance from CPMI-IOSCO on areas such as stress testing;
- The implementation of credible recovery plans; and,
- The development and implementation of resolution frameworks that adequately address the complex, and at times finely balanced, issues involved.

To deliver this requires international cooperation across the relevant authorities, CCPs and their users who play a vital role in holding a CCP's management to account and ensuring the highest risk management standards.

The agenda for 2016 I have outlined is crucial to delivering the G20 commitments around central clearing and I look forward to engaging with you on it.

Thank you