

Stock exchange consolidation

Comment: Systemic derivatives reforms require greater vigilance
Two reports shed light on ability to recover from shocks



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When Group of 20 leaders gather in China next month, an item for discussion will be how to further strengthen the resilience of some important “fixtures” in the plumbing of the financial system.

In the lead-up to the G20 summit, the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions have published two reports that shed light on the system’s current ability to recover from shocks and provide suggestions on valves or taps that need to be tightened or replaced.

Before the financial crisis, clearing and settlement of over-the-counter derivatives, such as credit default swaps, was a byzantine mess of bilateral obligations with poor risk management and no genuine transparency on exposures for either participants or authorities.

As mandated by the G20 in 2009, most OTC derivatives trades now pass through a

go-between, a so-called central counter party (CCP), or clearing house, for example LCH, Eurex Clearing and CME Group. It becomes the buyer to every seller and the seller to every buyer, reducing the risk to individual banks or asset managers, providing clarity on exposures, and optimising the amount of collateral to be posted against them.

Although some argue that increased use of CCPs amounts to “putting all your eggs in one basket” and that they have become the new “risk monsters” of the financial system, the situation that prevailed pre-crisis was manifestly more risky, complex and opaque.

We saw this with the failure of Lehman Brothers. The issue is not whether CCPs concentrate risks (they do) but how well they manage their risks, including risks they pose to others, and the extent to which they are a source of strength during market stress.

Our joint Principles for Financial Market Infrastructures published in 2012 set out risk management guidelines to promote robust CCPs and other “fixtures” such as payment and settlement systems and central securities depositories.

We are now working to make sure that the principles are not only adhered to around the world but also applied in an even manner to level the playing field. We are providing more detailed guidance based on industry feedback, lessons learned and emerging best practices.

These [“twin” reports](#) are the latest manifestations of this work. The first one assesses how a global sample of CCPs have put the principles into practice. Our analysis shows that CCPs have made important and meaningful progress in applying the principles, but also identifies a number of gaps and shortcomings.

These include — in some cases — insufficient planning when a member firm defaults on its obligations, inadequate procedures to maintain minimum financial resources at all times, and deficiencies in testing liquidity stresses. All CCPs should review the lessons in the report in light of their own operations and risk management practices. Any shortcomings should be addressed urgently.

The second seeks industry feedback on more detailed guidance on how CCPs can further boost their defences against shocks such as liquidity shortfalls or member defaults. This guidance includes clearer expectations on the rigour of credit and liquidity stress tests used in determining the level of financial resources that a CCP should maintain and on a CCP’s contribution of its own resources to cover losses arising from a member default.

Importantly, the reports complement our other efforts to strengthen the infrastructure supporting global financial markets, such as how to better protect these key fixtures against cyber risk. This includes a goal of having critical services back up within two hours of a major cyber attack. We have confidence in the industry’s ability, over time,

to meet this ambitious requirement in a similar way that it was able to achieve the same objective for physical disruptions.

We, along with the other stakeholders, are working to build a stronger and more robust plumbing system for the global financial markets. It is clear to us that the risk of default cannot be eliminated from the global financial system — to do so would imply unsustainable costs and severely restrict or even prevent businesses from using derivatives to manage commercial and financial uncertainty.

So the aim is to limit the potential systemic risks arising from any default as much as possible by encouraging central clearing and then applying a robust but proportionate approach to back up financial buffers and risk control.

The industry has made great strides in improving the risk management of CCPs over the years, but more work remains. As Mark Twain once said: “Put all your eggs in the one basket and — watch that basket!”

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