## Benoît Cœuré: Risks in Central counterparties (CCPs)

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the policy panel during the conference "Mapping and Monitoring the Financial System: Liquidity, Funding, and Plumbing", organised by the Office of Financial Research and Financial Stability Oversight Council, Washington DC, 23 January 2014.

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*I would like to thank Andreas Schönenberger for his contribution. I remain solely responsible for the opinions contained herein.*

*Accompanying slides can be found on the European Central Banks' website: [http://www.ecb.europa.eu/press/-key/date/2014/html/sp140123_1.en.pdf](http://www.ecb.europa.eu/press/key/date/2014/html/sp140123_1.en.pdf).*

Ladies and Gentlemen,

I am delighted to participate in this policy panel today on a topic of high importance to the ECB from the perspective of monetary policy implementation, financial stability, and banking supervision.

Central counterparties (CCPs) play a key role in the financial markets by managing and structuring a complex web of counterparty risk. As such, risks in CCPs are of interest to CCPs themselves, their clearing members and the regulators who supervise them.

What I would like to do in my brief introductory remarks is therefore not only to focus on the risks *in* CCPs, but also and importantly on the risk *of* CCPs.

The growing importance of CCPs certainly brings a number of important benefits that alternative bilateral arrangements could not do to the same extent. However, the rise of central clearing may also be accompanied by some unintended side effects that need to be addressed.

### The growing importance of central clearing

First, however, let me illustrate the growing importance of central clearing on the basis of some figures ***[Slide 2].*** The figures show the importance of CCPs already today for interest rate and credit derivatives in Europe. There are also CCPs for cash products and the role these CCPs would play for collateral pools of triparty repos is of increasing importance.

With the forthcoming implementation of the central clearing requirement for standardised OTC derivatives contracts, the volume of transactions cleared by a CCP will rise significantly also in that market segment over the coming years [***Slide 3***]. A recent quantitative impact study run by the Working Group on Margining Requirements of the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) estimated that the global volume of centrally cleared OTC derivatives could rise from a notional value of USD 142.7 trillion, or around 28% of OTC derivatives traded, to USD 268 trillion after migration to the clearing requirement, or 53% of OTC derivatives traded. All these figures quite forcefully demonstrate the increasing systemic importance of CCPs.

Now, why is there such a push for central clearing and what does that mean from a systemic risk perspective?

### Central clearing: benefits and side effects

I see four main benefits that explain the market-driven and regulatory push for central clearing ***[Slide 4].***

First, CPPs overcome information asymmetries that typically exist in marketplaces, especially markets with a big number of heterogeneous players. CCPs allow participants to trade with one a single counterparty (the CCP), which greatly facilitates the due diligence efforts and risk management burden that counterparties normally face.

Second, CCPs offer state-of-the-art margining and risk management methods that do not exist to the same extent in the bilateral world, which either relies on standardised margining methods that are not very risk-sensitive or on bank-internal margining models that may not necessarily meet the same high standards that CCPs are required to meet.

Third, by introducing default and clearing funds, CCPs are able to mutualise losses in a transparent and predictable way, which makes it easier for financial markets to handle huge losses and liquidity shortfalls that may occur in catastrophic events. By carefully designing their risk management framework, CCPs can help to ensure that losses fall predictably on those who are better able to cope with them. More generally, central clearing introduces *ex ante* transparency and therefore certainty, provided that the rules are clear and well understood by market participants.

Finally, and most importantly, central clearing allows for the multilateral netting of exposures so that a given level of risk protection can be achieved with a smaller amount of collateral, or vice versa, a given amount of collateral can achieve a higher level of risk protection.

Notwithstanding the numerous benefits of central clearing, the rise of central clearing may be associated with a number of side effects [***Slide 5***].

First, risk concentration within CCPs will grow, both nationally and internationally. CCPs are increasingly turning into institutions of unprecedented systemic importance. Their failure could lead to very serious systemic disruptions, which is why not only sound risk management, but also an effective recovery and resolution regime for CCPs is key.

Second, a growing number of banks will participate in key CCPs across the globe. It is essential that the financial institutions that participate in and rely on CCPs are able to conduct effective due diligence to understand the risks they face as members and take appropriate steps to mitigate those risks.

Third, owing to mutualisation, losses and liquidity shortfalls in the event of a member default may spread to other participants. Crisis propagation may be further driven by interdependencies of changing complexity. These can exist between CCPs and other financial institutions, for example, through interoperability arrangements. Note that the same large financial institutions, being clearing members of many CCPs, increase interdependencies even in the absence of interoperability.

Finally, existing differences in regulation may lead to regulatory arbitrage and potentially to a race to the bottom. Moreover, the use of a centralised infrastructure depends, in some instances, on exemptions from registration or the application of equivalence or substituted compliance with foreign infrastructures. Where foreign CCPs cannot be used, compliance with mandatory clearing under domestic laws may inhibit cross-border transactions.

### New risks related to central clearing

The globalisation process has triggered a trend towards global clearing that in itself may lead to further unintended consequences and may create new risks [***Slide 6***]. The trend towards increasingly large global CCPs is similar in nature to that of horizontal integration which the Committee on Payment and Settlement Systems (CPSS) looked at in greater detail in a report of 2010[1], concluding that larger global CCPs may have certain advantages, but may also lead to systemic risks, reduced benefits of central clearing, and regulatory frictions.

Moreover, it appears that for many banks, indirect access is their preferred way to get access to clearing services so as to comply with the clearing obligation. Client clearing seems thus to be dominated by a few large global intermediaries. A factor contributing to this concentration may be higher compliance burdens, where only the very largest of firms are capable of taking on cross-border activity. This concentration creates a higher degree of dependency on this small group of firms.

There are also concerns about client access to this limited number of firms offering client clearing services. For example, there is some evidence of clearing firms "cherry picking" clients, while other end-users are commercially unattractive customers and hence unable to access centrally cleared markets.

These are all developments that I believe the international regulatory community may wish to carefully monitor and act on as and when needed.

**The consequences of regulatory reforms**

There are a number of (sometimes unintended) consequences of regulatory reforms that CCPs, regulators, and clearing banks need to respond to [***Slide 7***].

First, perhaps most obviously, the growing reliance and importance of CCPs calls for higher risk management standards, which has led to the revision of the CPSS-IOSCO Principles for financial market infrastructures, specifying a number of new and/or more demanding requirements for CCPs[2].

Second, it is essential that the financial institutions that participate in and rely on CCPs are able to conduct effective due diligence to understand the risks they face as members and take appropriate steps to mitigate those risks. It is very welcome therefore that the Payments Risk Committee issued last year their "Recommendations for Supporting Clearing Member Due Diligence of Central Counterparties"[3], which complement CPSS-IOSCO new quantitative disclosure requirements. It is also important that banks are subject to strict capital and liquidity requirements on their exposures to CCPs, while at the same time preserving the incentives for central clearing.

Third, given the dramatic consequences that a CCP default would have for financial stability, it is vital that there are robust recovery and resolution regimes for CCPs. The CPSS-IOSCO and Financial Stability Board (FSB) have made good progress to that end.

Fourth, it is important to react swiftly to any structural developments that may cause systemic disruption. The FSB and the standard-setting bodies, in particular the CPSS, continuously monitor any such developments to that end.

Finally, I would not exclude that there could be a need for further adaptations and guidance on some selected regulatory requirements for CCPs if needed to ensure cross-border consistency in regulation. In addition to the recognition processes by individual jurisdictions, the ongoing monitoring by the CPSS-IOSCO of the implementation of the Principles for

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1 See Committee on Payment and Settlement Systems, "Market structure developments in the clearing industry: implications for financial stability". Report of the Working Group on Post-Trade Services. November 2010.

2 See Committee of Payment and Settlement Systems, "Principle for Financial Market Infrastructures", April 2012. http://www.bis.org/publ/cpss101.htm.

3 See Payments Risk Committee, "Recommendations for Supporting Clearing Member Due Diligence of Central Counterparties", 5 February 2013.

financial market infrastructures provides an opportunity to identify possible inconsistencies at a global level[4].

## Conclusion

Let me conclude [***Slide 8***].

The trend towards more central clearing is welcome and needed as it helps to manage risks better than bilateral clearing could. However, the greater use of CCPs concentrates and redistributes risks and may even create new risks.

Much progress has been achieved by CCPs, banks and authorities to ensure high risk management standards of CCPs and enable clearing members to conduct due diligence. It strikes me however that further efforts are needed to be able to cope with CCP default, to address risks associated with changes in market structures, and to remove cross-border differences in regulation where needed.

I thank you for your attention.

[4] See "CPSS: Implementation monitoring of standards", http://www.bis.org/cpss/cpssinfo2_5.htm.