Dealing with financial market infrastructures under stress -- no sinecure

Event Report on the launch of the 2nd interim report of the CEPS Task Force on Implementing Financial Sector Resolution

In response to the financial crisis, authorities have given a greater role to financial market infrastructures (FMIs), and specifically to central counterparties (CCPs), without fully addressing the question of their resolvability. CCPs clear derivative trades for the largest international banks, which makes them systemic by their very nature. Since business continuity is of paramount importance, standard insolvency procedures are widely excluded as a feasible option. EU authorities are contemplating a proposal on the subject, but some crucial issues remain unresolved, such as the statute of CCPs, access to central bank liquidity, the role of resolution authorities, the application of the 'no creditor worse off' principle or the burden sharing in case of non-member default losses.

A new CEPS Task Force report, entitled "How to deal with the resolution of financial market infrastructures" and launched on 19 October 2016, recommends that European rules on the subject should focus on facilitating coordination between supervisors and authorities around the globe. The report calls upon the authorities to exercise restraint before triggering action towards FMIs, and to ensure that they have sufficient time to put recovery or resolution requirements in place when necessary. The latter should allow that the loss allocation ('waterfall') process, especially in a CCP, can be completed over a 'resolution weekend', and that the default fund can be replenished.

During the presentation of the report, Patrick Pearson, head of unit in DG FISMA, European Commission, and Dennis McLaughlin, Chief Risk Officer of LCH.Clearnet, highlighted the growing systemic nature of CCPs as a result of the G20 requirement to centrally clear derivatives trades. Pearson spoke of a concentration of risk in CCPs, with total notional exposures of around $500 trillion – or 30 times the EU's GDP. The industry is global by nature, concentrated and extremely interconnected. The EU has elected to wait for the international response before formulating its own proposal. In addition, the EU could not simply copy and paste elements of the bank resolution framework, such as the 'no creditor worse off' principle, as critical services should be continued. There is possibly also no need for a 'presumptive path' of recovery, as much will depend on the circumstances. Another open question is the supervisory structure, which will most likely be based on the 'colleges of supervisors' concept, which seems outdated and ineffective for such concentrated business.

For LCH, McLaughlin reported that the layers of defences are well defined in its rulebook, but the concentration risk has increased, as well as the pro-cyclicality of the business and the non-traditional risks, such as cyberattacks. He also saw the decline in the Futures Commission Merchants (FCM), the intermediaries that bring clients to CCPs, as a sign that fewer entities were willing to provide this service. He raised the unresolved issue of access to central banks as counterparties, but this was not universally accepted. As for handling stress situations, he referred to rules and procedures of LCH, but there remains the question of how to handle non-member default losses. As for loss allocation, increasing the loss-absorbing capacity will reduce the profitability of LCH below its cost of equity, or increase the cost of clearing. Hence, the question arises of whether a resolution authority will decide on loss allocation in situations of stress, or will it run an auction system?

This timely and authoritative report is the result of deliberations in a CEPS Task Force that examined the rules on resolution of banks and financial market infrastructures. The group is chaired by Thomas Huertas and composed of financial sector representatives, experts and officials. The full report is available for downloading www.ceps.eu.

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CEPS CEO, 21.10.16