CCP risk management and procyclicality

MMCG

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Frankfurt, 1 June 2011

Public initiatives in the field of central clearing

- G 20 mandate (09/2009) on OTC derivatives: reporting to TRs, mandatory central clearing, mandatory trading on exchanges
- Legislation: EMIR; Dodd-Frank
- BCBS proposals on capitalization of bank exposures to CCPs
- CPSS-IOSCO standards

- Central clearing superior to bilateral risk management: (i) CCP margining is most sophisticated risk management method, (ii) risk mutualisation and loss sharing help to sustain major defaults.
- Further benefits: multilateral netting, improved liquidity, trading anonymity, operational efficiency
- CCPs need to be safe: risk management includes requirements on participation, margining, additional controls, and collateral

Procyclicality

- Background: CGFS 2010
- Definition: Positive correlation between changes in risk management practices (margins, haircuts) and business or credit cycle fluctuation
- Concern: such procyclical effects may exacerbate market stress, volatility, and financial instability
- Objective: CCPs to limit procyclical effects to the greatest extent possible

CPSS-IOSCO approach

- Recognizing trade off between micro-prudential needs (protect CCP) and macro-systemic implications (preserve financial stability)
- Principle 5 (collateral), key consideration 4: FMI to establish forward-looking, relatively conservative, and stable haircuts calibrated to include periods of stressed market conditions in order to reduce the need for procyclical adjustments
- Principle 6 (margin), key consideration 3: margin models should, to the maximum extent practical and prudent, avoid the need for destabilizing, procyclical changes

Impact on CCPs and banks?

- Need for more conservative margin requirements
- Individual risk mitigation measures to be seen in the overall context of the CCP's entire risk management framework
- The same level of safety can be achieved through different combinations of risks management tools: lower margin can be compensated by higher default fund contributions, cross-margining, different composition of collateral, or communication policies
- Risk management requirements for bilaterally cleared trades
- The ultimate effect on margin requirements depend on multiplicity of factors to be assessed by the relevant regulators and overseers