CFTC ROUNDTABLE ON CPMI-IOSCO GUIDANCE ON CCP RESILIENCE AND RECOVERY

OVERVIEW

For questions on the note below, please contact Daniel Austin at (202) 547-3035.

Yesterday, the CFTC held a public roundtable to discuss the recent CPMI-IOSCO guidance on central counterparty (CCP) resilience and recovery. The goal of the roundtable was to gather the perspective of different stakeholder groups regarding the impact this guidance will have in the context of U.S. derivatives clearing organizations (DCOs).

Key Takeaways

- There was disagreement among panelists about the adequacy of the stress testing guidance, and several calls for more transparency in stress testing.
- Several panelists called for a principles-based approach to addressing margin requirements.
- According to most panelists, the risk management governance guidance placed too much responsibility on the board of directors.
- Clearing members argued that although there is supposed to be competition amongst CCPs, there really is not much choice for clearing members.
- Panelists from CCPs and clearing members agreed that CCPs having skin-in-the-game was an important aspect of mitigating risk.

SUMMARY

Panel One: Stress Testing

Open Discussion

Stephen Berger, Director of Government & Regulatory Policy, Citadel: I do not think all of our stress test scenarios should assume that the value of all collateral is declining.

Sunil Cutinho, President of CME Clearing, CME: We want robust margin and stress testing frameworks. If you have an automatic trigger for collecting exposure, you suck a lot of liquidity out of the system, and put extreme strain on the system. If we are trying to cover extreme and plausible circumstances, we can go back in time and can see if there are gaps. Need to have distinct liquidity stress tests and also take into account what banking regulators are doing. We cannot look at CPMI-IOSCO guidance on its own. The living will process helps maintain continuity of access.

William DeLeon, Managing Director/Global Head of Portfolio Risk Management, PIMCO: We understand the need that stress testing information be made public, but if it becomes public, we run the risk that prescriptive stress testing will cause confusion in analyzing CCPs' varying stress test results. It is important that liquidity stress testing take into account co-linear relationships. There needs to be a well-defined structure that addresses who, what, when, and how payments are made when a stress event occurs.

Nicolas Friedman, Managing Director in Credit Risk Management, Goldman Sachs: We are pleased with the guidance, particularly with the identification of various risks during stress testing. Liquidity and credit stress testing is incredibly complex, so disclosing how CCPs interpret certain stress scenarios is important. We need to look beyond just credit defaults or default of largest members in stress scenarios.

Eileen Kiely, Director, BlackRock: Stress testing is critical to safety and soundness and something so critical requires guidance. Stress testing should mirror day-to-day practices and credit liquidity testing should require input from other key participants.

Dale Michaels, Executive Vice President Financial Risk Management, Options Clearing Corporation (OCC): There should be some connection between credit and liquidity stress tests. We are for transparent stress testing, but it would be difficult to craft a one-size-fits-all stress test.

Chris Perkins, Managing Director/Global Head of OTC Clearing, Citi: The guidance is not specific enough. Rather than focusing on stresses in the traditional way, stress is being allocated via concentration assessments to mitigate risks.

Sebastien Renard, Executive Director/CCP House Clearing Risk Management, Morgan Stanley: We believe there is not enough stress test transparency. Clearing members should receive better disclosure from clearinghouses so they can better assess things like liquidity.

Marnie Rosenberg, Global Head of Clearing House Risk, JPMorgan: The guidance on stress testing is excellent and comprehensive. From a global perspective, we see differences in structures within different clearinghouses, so I would be careful in suggesting synchronized stress tests. The guidance should set thresholds on credit lines.

William Thum, Principal, Vanguard: We are focused on transparency in our decision making in terms of clearinghouses and clearing members. The tests should include potential sources of liquidity risks. We are focusing on the inter-relationship between clearinghouses, clearing members, the products traded, and the risk that could arise if a market participant defaults to a clearing member and the cascading risks that could rise as a result of the interconnectedness.

Panel Two: Margin Methodology

Open Discussion

Berger: We agree there should not be a rigid time minimum prescribed.

Cutinho: Margin period of risk (MPOR) is a function of the product's risk profile. A lot of factors are involved in determining margin like liquidity in the product. There should be a process where regulators discuss these topics with the private sector. CCPs should be very aware of their impact on the broader ecosystem. We believe in predictability and transparency. We look at the impact of our actions on our firms and their clients when it comes to pro-cyclicality.

DeLeon: We agree that any prudent risk management system should factor for pro-cyclicality, and it should be principles-based, not prescriptive. Unfortunately, there is no forward way to look at pro-cyclicality. Need to have a principles-based model to which a board can agree.

Friedman: Margin requirements should be more formulaic. It could be prudent to increase initial margin (IM) before anticipated macro events. The guidance could be strengthened through a targeted back testing on certain portfolios.

Scott Hill, Chief Financial Officer, ICE: We have to take into consideration all aspects of the model. There are many factors that should determine the methodology. Less prescription in this area is better. We have to look at variation margin (VM) and other factors and ensure that margin models address these factors. I am very much in favor of a principles-based approach. Any margin model and every element ought to be able to address how it deals with, and mitigates, pro-cyclicality.

Kiely: Volatility floors are appropriate when it comes to pro-cyclicality. As an end-user, we need the ability and transparency to predict what the margin call will be.

Michaels: We seek a margin framework that is transparent, appropriate, and approved by the appropriate board. We support some transparent measured margin increases before an impactful event occurs.

Perkins: Margin requirements should be based on the underlying liquidity of the product and based on quantitative and qualitative factors. The practice of one-sided calling further exacerbates pro-cyclicality. The vast preponderance of risk should be covered by IM. We want CCPs to mitigate stress.

Rosenberg: We look at all of our listed derivative memberships globally. We do not think the methodology is transparent and addresses the concentration with some of the largest members. A problem with IM is predictability and transparency. We like the 25% buffer but with the ability to use that buffer in a crisis - having a buffer is a good practice.

Thum, Principal: We cannot talk about MPOR in isolation. Buy-side participants were frustrated by MPOR 5-day rule for uncleared swaps; it appeared arbitrary. If there is no minimum floor for MPOR, how is the system credible? This is where stress testing can play a significant role.

Marcus Stanley, Policy Director, Americans for Financial Reform: Just because IM is stable does not mean it is not contributing to pro-cyclicality.

Panel Three: Governance, Transparency, CCP Contributions to Losses & Recovery

Open Discussion

Isaac Chang, Managing Director/Co-Head Trading, AQR: We represent investors who take risk in the cleared derivatives market. In theory there is competition in the marketplace, but in reality, there are not that many choices. CCPs pose operational risk. In a resolution scenario, our main objective is addressing the arbitrariness of the distribution and allocation of losses.

Paul Cusenza, Chief Executive Officer, Nodal Exchange: Very important to have feedback mechanisms for clearing members. Feedback from clearing members should be available on a universal basis. There needs to be a mechanism for feedback, and clearing members should have a direct line to the board. Skin-in-the-game is the right model, but it should not be prescriptive.

DeLeon: We agree that the governance language is not clear, and board members should be in an oversight role, not day-to-day management. The board has a responsibility to ensure that the committees doing functional work are carrying it out and an audit framework is in place to examine that work. Directors do not need to be subject matter experts.

Andrés Fernandéz, Managing Director, Bank of America Merrill Lynch: We like that the guidance places specific responsibility on the board.

Friedman: The recovery tools developed by the CCP should be reviewed by clearing members.

Hill: The definition of "intent" is not adequately clear in the corporate governance guidance. We introduced skin-in-the-game for commercial reasons. CCPs do not introduce risk, they manage it.

Lindsay Hopkins, Clearing House Counsel, Minneapolis Grain Exchange: We agree that the board should be responsible for risk management framework.

Christal Lint, First Vice President/ Deputy General Counsel, OCC: Seeking and soliciting your clients' input is important for any business and should be a part of the CCP strategy.

Perkins: We would like to see greater guidance for skin-in-the-game.

Renard: We believe the guidance is clear, appropriate, and transparency is key. Further work needs to be done to establish a forum for feedback from clearing members.

Roshan Robert, Director, Agency Derivatives Services, Barclays: The guidance does speak about delegation of authority to management. CCPs' discretionary powers could be elaborated upon more in the guidance.

Rosenberg: The guidance suggests that the board obtain input related to margin methodology and stress tests. We think the input from members should be broader (i.e. significant risk matters). We believe the public consultation process is important and serves a vital interest, and that input needs to be provided on the front end. Clearinghouses and their parents should be fully responsible for any losses from a non-default perspective.

Kim Taylor, President, Global Operations, CME: One problem with the governance language is that the board has explicit responsibility for certain decisions. There are mechanisms for clearing members to provide feedback to clearinghouses, but there are risks in over sharing aspects of stress testing. We have had skin-in-the-game since the 1970s-80s, and the people who bring risk to the clearinghouse are the clearing members. The reasons clearinghouses have worked in times of crisis are the risk and default management mechanisms they have in place. Legislating a one-size-fits-all definition of skin-in-the-game is not a good idea.

Thum: We believe that CCPs are fiduciaries and are not just utilities. They are commercial enterprises holding large sums of capital. If CCPs fail, the buck should stop with their equity holders. CCPs are a monopoly, and the dealers dictate which CCPs we use. We have given input to CCP risk committees and some have listened while some have not. We think something prescriptive needs to be done.

Stanley: We view clearinghouses as having a critical public utility dimension. Their reliability is a central issue in financial regulation, and we are concerned by clearing member and end-user statements that they do not have enough insight into clearinghouse resources. Just because IM is stable does not mean it is not contributing to pro-cyclicality. We support clearinghouse skin-in-the-game to align incentives, and there should be a floor.