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‘Too big to fail’ worries reach clearing houses

Philip Stafford Author alerts

Clearing houses, which sit between two sides of financial trades, have become risk managers for global markets in the post 2007-crisis era. But they are having to defend their role in a growing debate over what would happen if one of them failed.

Operators such as LCH.Clearnet, Deutsche Börse’s Eurex and CME Group are increasingly at odds with their users – including the world’s big banks – as global regulators continue their reforms of bilateral, or “over-the-counter”, derivatives markets.

The question is who would take the losses in the event of a failure: the clearing houses themselves; their member banks; investors, such as pension funds; or governments.

In their efforts to make the financial system safer, policy makers have pushed for more OTC derivatives to be processed through clearing houses, known in market jargon as “central counterparties”, or CCPs. CCPs guarantee deals if one side defaults before they are completed.

However, the shift has left responsibility for ensuring the safety of the huge OTC market – which has a notional $691tn in outstanding contracts – centred on just a handful of institutions.

Now central banks in Europe and the US are turning their attention to developing frameworks that ensure the system can keep functioning when a clearing house runs into trouble – and without governments picking up the bill.

“We need to have a broader debate on what happens when we’ve burnt through the cover,” says Patrick Pearson, head of market structure in the European Commission markets directorate. “It can go in a few hours. Is there something there before we go to the taxpayer? It’s at the top of the regulatory radar screen.”

The EU’s executive arm will set out its policy proposals next year. Policy makers are adamant that taxpayers should not bail out failing clearing houses, and recent rule changes such as the Dodd-Frank legislation in the US and Europe’s market infrastructure legislation have set out tougher default procedures, creating a “waterfall” of financial resources that can be drawn on when crises hit.

But crucially, clearers have to agree recovery plans with their members – the financial institutions that use their services. That has resulted in a fractious debate between clearing houses and some of their most biggest users, notably JPMorgan, Pimco and BlackRock.

One of the most contentious issues is the size of contributions that CCPs should make to default funds. Market practitioners argue that more “skin in the game” from clearing houses would incentivise them to manage their risks.

CCPs should offer more transparency and make “significant” direct contributions to their own standard default funds, according to the International Swaps and Derivatives Association. “Special attention . . . needs to be given to ensuring CCPs are as safe as possible. The incentives have to be right for all participants,” says Scott O’Malia, Isda’s chief executive.

But clearing houses complain of unfair differences in regulatory requirements. European rules, for example, require clearing houses to have skin in the game equivalent to 25 per cent of their minimal capital resource. US rules are not as prescriptive. Moreover, Thomas Book, chief executive of Eurex Clearing, warns of moral hazard risks. “If a CCP increases its ‘skin in the game’, the bank reduces its own skin in the game. You need to keep members highly incentivised,” he says.

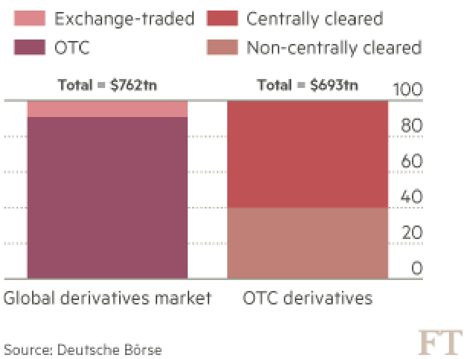
Other proposals are also proving controversial. In October the Bank for International Settlements and the International Organisation of Securities Commissions (Iosco), an umbrella group of regulators, produced policy guidelines on steps failing clearing houses should be allowed to take when crises erupt.

They included tearing up derivatives contracts, applying a "haircut" to margins (or collateral posted as security), allocating any uncovered losses to members and replenishing any funds that were used up during a "stress event".

But the proposals have led to fears that they give too much leeway to CCPs, and leave the rest of the market with unquantifiable exposures. Some warn that applying haircuts to margin is tantamount to expropriating assets that belong to asset managers and pension funds. The US and Europe also have differing rules over how clearing houses segregate the margin of their customers.

Derivatives market today...

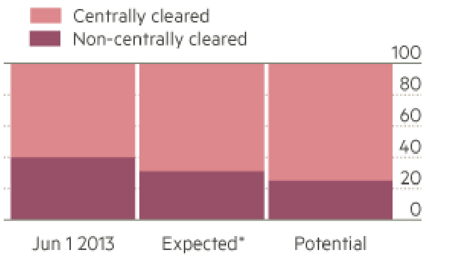
% of total



Source: Deutsche Börse

...and how pushing deals through clearing might change it

Outlook of central clearing of OTC derivatives



* Once the clearing obligation is implemented in 2017-18

Source: Deutsche Börse

"No one can say how big the shortfall at a troubled CCP will be, because you would of course be dealing with a systemically unstable situation," says Angus Canvin, senior adviser, regulatory affairs at the Investment Management Association.

Policy makers have also begun to examine whether clearing houses should have a standard amount of "total loss absorbing capacity" (TLAC) similar to requirements imposed on banks.

TLAC standards set the minimum amount of capital and liabilities that can be written off when a major bank gets into serious trouble, avoiding the need for taxpayers to pay out – as they did in the 2007-09 financial crisis.

But Damian Carolan, a partner at Allen & Overy, the law firm, says some of the proposed changes have not been properly thought through. "There are certain issues that would not be resolved by more TLAC," he says. "Users want certainty over what will happen and don't want potential unlimited liabilities put on them. It's a direct tension with wanting every tool in the box for clearing houses."

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