

Keynote speech

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The journey of addressing risks in central clearing: volatile but upward trend

Since the inception of central clearing, its inherent risks have been studied with the aim to understand, manage and reduce them. An early research article on managing central clearing risk is from Ben Bernanke in 1990.¹ He described how clearing and settlement systems were impacted by the 1987 crash, and the interplay between severe operational and financial stress at clearing members with heavy liquidity demands throughout the financial markets. Although the clearing system helped avoid a chain of defaults, investor uncertainties about the viability of the clearinghouses intensified market fluctuations and distress. To end this crisis, the Federal Reserve stepped in with liquidity support. As this was not a structural solution, public and private entities started to cooperate to address the weaknesses that had been revealed.

One can see this as the start of a tradition of public and private entities jointly developing international principles to manage risks in clearing and settlement systems. In the early 90s, the Lamfalussy standards were issued and in 2004 the CCP Recommendations from CPSS-IOSCO. These were the basis for the international standards that we currently use, the Principles for Financial Market Infrastructures (PFMI), and related legislation. CCPs have actively engaged in the development of standards by providing input, and by strengthening their risk management rules, procedures, and practices.

Where are we now, in 2023, on that journey of studying and addressing risks in CCPs? Overall, it is my strong belief that CCPs have strengthened their risk management up to a level where they have proven to be resilient to large price shocks. At the same time, there is no reason for complacency. The world may be equally or more uncertain than before, with obvious geopolitical tensions. Within the EU we see ongoing changes, such as moves of cleared volumes in equity markets and potentially commodities markets. And we see innovations in technology that require new approaches. In my remarks today I will highlight a few types of risks that EU CCPs, and their ecosystems, are exposed to, and which warrant our attention in the foreseeable future.

Procyclical nature of margin

¹ Ben Bernanke won in 2023 the Nobel prize in economics for his research of financial crises.

A first and heavily debated risk for financial stability that needs to be addressed by both public authorities and CCPs concerns the procyclical nature of CCPs' margin models, which became evident during recent crisis, notably the COVID-19 and energy crisis. It is a topic that is prevalently shining on the agenda today and my colleague Andreas Georgopoulos will present detailed findings on APC tools in the commodities market.

It is clear in all recent crisis events that the CCPs were resilient and generally able to continue their critical operations. However, the high margin calls, following high prices and volatility, put significant liquidity stress on clearing members and clients, up to a level that governments developed programs for public guarantees.

Where are we in addressing this risk? There's broad agreement that procyclicality risks need to be better addressed. The existing principles and regulations need to be further strengthened to reduce the negative impacts of sudden price and volatility movements on the ecosystem of CCPs.

At the international level, ESMA contributes to the work of the international standard setters on margin, including the report of the Basel Committee on Banking Supervision, CPMI and IOSCO that was issued in August 2022. The report includes policy proposals in terms of margin transparency, governance and APC metrics and I hope this supports developing further guidance in 2024. A consultation is planned to commence in a few weeks.

ESMA itself has adopted, in July, targeted changes to its EMIR Regulatory Technical Standards (RTS) on Anti-Procyclicality measures to mitigate the potential impact on clearing participants of big step margin changes. The revised technical standards aim to harmonise the policies and procedures for selecting and reviewing the anti-procyclicality margin measures, and to provide more granularity on the design and use of specific tools, while ensuring sufficient flexibility for the CCPs to adapt to given market situations.

A widely mentioned measure would be to increase the transparency around margin models to better prepare clearing members and clients for potential margin calls of CCPs. Public authorities are jointly revising how margin transparency can be enhanced, in terms of both the transparency of CCPs vis-à-vis clearing members and the transparency of clearing members vis-à-vis clients. The European Commission has proposed in EMIR 3 to extend margin simulation tools to clearing members to ensure that clients are adequately prepared.

Operational risk

A second type of risks that warrants attention is operational risk. It is a broad category that entails many different types of operational issues (systems, processes, human errors, external events), and as such requires dedicated risk expertise, which is not always easy to find. The need to manage operational risk is evident, given that CCPs' interconnectedness with other market participants would allow operational disruptions spreading through the system, causing potentially liquidity risks, financial losses, and generally a loss of trust in the financial system.

This type of risk requires a forward-looking perspective as evolutions in technologies go fast and risks are continuously changing. Relevant issues at the moment are the move to cloud models, the growing importance of fintech, the increased sophistication of cyber risks, and the increased dependency on a few service providers. In this context I would also like to mention the increased dependency on a limited number of clearing members.

Operational risk has been studied and managed for decades. Let me mention a few ongoing measures to enhance the EU financial system as a whole.

Important regulatory measures at the EU level include the development of the Digital Operational Resilience Act, or DORA, which is now in force and designed to address the fundamental threat of cyberattacks and ICT disruptions in the EU financial sector. At ESMA we're currently developing the underlying RTSs and are coordinating with national competent authorities to support preparedness of supervised entities.

Another relevant initiative is undertaken by the ECB and aims for the implementation of the CPMI-IOSCO guidance for FMIs on cyber resilience. An important assessment tool is the so-called Cyber Resilience Oversight Expectations (CROE) that the ECB uses to analyse and enhance the level of cyber resilience of individual FMIs. Also, a European Red Team Testing Framework (TIBER-EU) has been developed, targeting the people, processes and technologies of an FMI.

In its 4th Stress Test exercise, ESMA published for the first time an operational risk component that provided an EU wide picture of the exposure of CCPs to critical third-party service providers. We identified not only differences in exposures across CCPs but also the critical third-party service providers with the highest systemic importance for the CCP sector. We will continue our analysis both at an individual CCP level, as well as system wide.

I would also like to mention an important global and joint effort, which is the multi-CCP fire-drill planned for next month, in which more than 30 CCPs across the world (including the majority of EU CCPs) will simulate the default of a large clearing member and run their operational default management processes. Clearing members and regulators are also involved in this simulation, allowing for a comprehensive test of operational readiness of CCP staff, procedures, IT systems and communication with stakeholders. The multi-CCP fire-drill adds to individual CCP fire-drills because it can identify dependencies and bottlenecks which otherwise remain unseen, for example, clearing members receiving several competing requests for seconding traders to the CCPs or to price portfolios.

Is this sufficient? Let me answer that by mentioning that CPMI-IOSCO has recently set up a dedicated standing group on operational risks, in which my colleague Klaus Löber is one of the co-chairs.

Other risks

The array of risks to which CCPs are exposed is broad. Let me mention one more type, which are governance related risks. CCPs operate in a competitive environment, which brings along the risk that competition is not only taking place in the area of fees and innovation of services, but also in defining the size of financial resources that clearing member should provide to the

CCP in the form of margin and default fund contributions. I'm convinced that the PFMI and EMIR provide a floor to avoid a race to the bottom. However, the challenge is to ensure across CCPs that requirements are indeed met consistently to support a level playing field. Related to this is that nowadays all CCPs are part of a group. How do we ensure that CCPs remain sufficiently independent in that group to focus on its objectives of managing clearing risks and avoid conflicts with other objectives in the group?

I cannot conclude this speech on systemwide risks without mentioning the EU's exposure to UK CCPs that are of systemic importance to the EU. Almost two years ago, in December 2021, ESMA published a statement on the systemic importance of the UK Tier 2 CCPs, concluding that some clearing services from UK CCPs are of substantial systemic importance to the EU, creating significant dependencies.

As we speak, the legislative process is ongoing following the publication of the Commission's proposal on EMIR3 in December last year. We look forward to the conclusion of the legislative process, in particular measures to address the identified overreliance on UK CCPs, and enhancements to the EU CCP supervisory framework.

Conclusion

To conclude, during the last decades CCPs and their regulators and supervisors made big strides in identifying, managing, and reducing risks in central clearing. A regulatory and supervisory framework has been created with the objective not to use emergency liquidity or taxpayers' money, but rather have CCPs contribute to financial stability by stopping losses spreading through the system.

In an environment of ongoing changes and uncertainties we need to continue to work together, public and private entities, and have a holistic and systemic focus on risks.

Thank you for your attention.