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Keynote Address – Key trends in cleared derivatives

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I am pleased to be back in Frankfurt to address you today in my capacity as Chair of the CCP Supervisory Committee (CCP SC).

Since the CCP SC was established in January 2020, we have seen two major crises events in short succession testing the resilience of our financial system, as well as our regulatory and supervisory approach to CCPs.

After a longer period of stability, the COVID-19 pandemic and then the Russian invasion of Ukraine have had major repercussions on financial markets creating strong supply and demand shocks, fuelled by shortage fears, exacerbating volatility notably in gas and oil products.

These significant price corrections and volatility increases in turn generated steep margin changes for clearing participants, and in some instances significant liquidity strains in parts of the financial system.

From a CCP perspective, the impact so far seems to have been contained: there were no CCP defaults and only minor member defaults, which were swiftly and effectively managed. At this stage, we have not identified major weaknesses, although some CCPs are reviewing their margin models and their list of eligible collateral. In turn, most clearing members seemed to have been able to cope with the increased liquidity pressures.

However, looking at the broader clearing ecosystem, a number of non-financial clearing members and clients were in significant distress and in certain cases needed financial assistance to avoid that the liquidity stress observed would become a solvency crisis and trigger multiple defaults.

We have also witnessed extreme stress more specifically in certain commodities, like the nickel market, where the market was closed for six days after prices more than doubled. These events also reveal deeper market structure issues, as the lack of transparency on client positions, especially in the OTC space, was hiding the extent of build-up of exposures held by one client across several clearing members only revealed by its inability to meet billions in margin calls following a short squeeze.

The magnitude of these live-tests – of which we may not yet have seen the end – are key in assessing the resilience of our system and identifying areas which can be improved. The CCP SC has already identified a number of lessons learned from these episodes.

Lessons learned for CCPs

APC margin measures – ESMA published a consultation at the beginning of the year where we have proposed to fine-tune the respective EMIR RTS to add a certain degree of granularity to help ensuring that these APC tools are applied in a consistent manner across the EU and that EU CCPs give due consideration to the potential procyclical effects of big step margin changes.

We will take the time necessary to review the responses and conduct additional research to make sure that the potential changes outlined in January remain valid following the market developments in March this year due to Russia's invasion of Ukraine, notably in the commodities space.

CCP Membership due diligence is another point which has come to the fore, and which will be the topic of our Peer Review for 2022 which has just been launched in the CCP SC. The aim is to make sure that NCAs have a common approach to review CCP Clearing Member due diligence, especially for Non-Financial Counterparties (NFCs) and clients. It will comprise a review of CCP participation requirements with a focus on the comprehensive annual review of NFCs, the criteria and arrangements of clearing members to allow their clients to access the services of the CCP, as well as additional obligations that CCPs may impose on NFCs.

Concentration risk – The recent stress at LME Clear, as well as the default of a clearing member at an EU CCP a few years back, have also highlighted the importance of understanding and managing concentration risk for commodity products. The 3rd and 4th ESMA CCP stress test exercises have shown that the concentration exposures for commodity products are significant and attract relatively low concentration add-ons. ESMA will interact with NCAs, on a CCP-by-CCP basis, to further strengthen the use of concentration add-ons to cover concentrations risks, where needed, including in commodity markets. Concentration risks will also be the topic of the CCP Peer Review in 2023/2024 including risks in relation to commodity derivatives and emission certificates.

Lessons learned for the broader ecosystem

Transparency – The incidents at LME Clear have also shown that significant client positions may build up due to the lack of transparency on client positions. Principle 19 of the PFMI outlines that a financial market infrastructure (FMI), including a CCP, should identify, monitor, and manage the material risks to the FMI arising from tiered participation arrangements. We will undertake, together with other authorities, further analysis to enhance the identification of indirect participants responsible for a signification proportion of transactions and the identification of material dependencies between direct and indirect participants that may affect the CCP.

Interconnectedness – the latest crisis has shown once more that CCPs play an important role in the transmission of price changes which may trigger liquidity needs for market participants. An in-depth analysis of the overall eco-system is important for the identification of specific vulnerabilities and risk management approaches for the clearing of commodities markets. We will work closely together with the ESRB and SSM in the analysis of the dependencies and interconnectedness of CCPs, clearing members and clients in the commodities market, but also on clearing members and CCPs being part of the same legal entity.

Lessons learned for supervisors

Real life stress tests are also a good opportunity for supervisors to assess whether supervisory responses have been adequate. We have recently started discussions as to what we can do better ourselves, amongst CCP SC members, but also how we can contribute to the discussion at the international level given the inherently global nature of most commodity markets.

Data collection and analysis – For example, throughout the crisis, the CCP SC has been a central point for monitoring developments at EU (and Tier 2) CCPs and for discussion with the NCAs supervising CCPs. This ad hoc set up has been particularly valuable in ensuring a coordinated approach to the market events and has shown the importance of developing such data collection and analysis structures on a more permanent basis for EU CCPs, but also the broader clearing ecosystem.

Crisis management framework – In addition, ESMA has started the development of an enhanced crisis management framework that could be used by the CCPSC to support crisis preparedness. The main elements of this crisis management framework will encompass) crisis procedures that include crisis management reporting; risk definitions with early warning indicators for potential crisis events; and the testing of the framework through a fire drill, which may include a communication exercise as well as a scenario testing exercise.

CCP stress-test

Of course, we do not and should not wait for crises to learn lessons and improve our systems. This is why our stress-tests enable us to test the resilience of EU and Tier 2 CCPs based on hypothetical scenarios.

As you will have seen, we published last week the results of our fourth stress test. The results confirm the overall resilience of CCPs to credit, concentration and operational risks under the tested scenarios and implemented framework.

A total of 15 CCPs were covered by the exercise, including two UK CCPs qualifying as Tier 2 CCPs. We have delayed the finalisation of the analysis to cross-check our findings against the real life experience in March this year.

In short, our findings are that CCPs have sufficient buffers to withstand adverse market developments in combination with the default of the two clearing members with the largest exposures.

However, gaps are identified between the necessary and available buffers or add-ons for concentration risks for some CCPs, particularly in commodity derivatives markets and to a lesser extent for equity products. ESMA also noted that not all EU CCPs have concentration add-on despite facing market impact.

The main novelty of this stress-test was to evaluate for the first time the exposure of CCPs to critical third-party service providers and the ability of CCPs to reduce risk through operational risk management tools. Through this process, we identified differences across CCPs in terms of risk sources, exposures and mitigation tools - as this was our first time testing these types of risk, we decided to keep the results anonymous.

Further work is needed to analyse exposures to third-party service providers both at an individual CCP level, as well as system wide, to further strengthen operational resilience.

We were nevertheless satisfied to that we were able to capture these new types of operational risks for CCPs for the first time and will continue refining our stress test methodology in this regard.

Going forward, our ambition at the CCP SC is to build a structured framework for stress-testing based on a multi-year plan to progressively challenge untested dimensions of CCP resilience.

Building on the results of the 4th CCP stress test, ESMA's CCP stress-testing framework will progressively expand to other emerging risks such as cyber threats and more complex and multi-faceted risks linked to climate change.

We issued recently a call for evidence to see which type of climate risks may be included as part of our stress-tests to ensure that CCPs remain resilient to these forward-looking trends. We are now still analyzing the feedback we have received and are discussing different options to ensure the CCPs remain resilient in the long-run and can adapt to meet these new challenges.

The expansion of the stress test would also be completed by a deepening of the existing parameters tests with permanent modules for testing liquidity risks in addition to credit and concentration risks.

ESMA will also work to improve the different scenarios analysed in cooperation with the ESRB and central banks of issue to simulate for example severe liquidity stress which would not result from a default, as observed in the past crises.

Of course, stress-tests remain hypothetical, and it cannot be assumed that we are able to test for all scenarios, especially as the ongoing crisis can reignite. Furthermore, remaining risks will intertwine with deeper shifts in monetary policy to address inflation, with at the same time a potential recession building on the horizon.

On this forward looking note, I thank you for your attention and hope these few thoughts will generate interesting discussions in your panels throughout the day.