AFR Americans for Financial Reform Education Fund

Remarks by Marcus Stanley, Policy Director, Americans for Financial Reform Education Fund, at the CFTC's Market Risk Advisory Committee Meeting to Discuss Clearinghouse and Vendor Risk Management held on December 4, 2018.

At bottom all these diverse papers address one issue: the resources available in the cleared derivatives ecosystem to protect against credit risk. Higher levels of such resources improve protections against systemic risk, but also increase the total cost of cleared derivatives to market participants.

Prior to the 2008 crisis, resources backing derivatives were far too low. Starting in 2001, notional swap volumes grew five-fold in just six years – an annual growth rate of 32 percent. As markets came under stress, those notional volumes were reflected in a massive growth of actual credit exposure - $3 trillion in new credit exposure just between the end of 2006 and the end of 2008. The resources were simply not there to handle that exposure.

It seems clear that swaps received an implicit safety net subsidy before the crisis. It is therefore appropriate that post-crisis regulation increase the resources backing swaps and thus their overall cost. This both makes the system safer and incentivizes a more economically efficient level of derivatives transactions. That level should align with their true social risks.

Of course mandatory clearing is a key tool in doing that. But clearing is not an end in itself but a means to reducing risk. It is not a magic bullet. An under-resourced clearing system will simply be a concentrated node of systemic risk.

With that as background, let me offer some specific thoughts on these proposals:

--Multiple proposals address capital held against cleared derivatives by clearing members. It will always be possible to question risk metrics at the position level. But I don't think that this discussion can or should be separated from the general question of clearing member solvency. Clearing member solvency is critical to the issue of CCP resiliency. Under current rules, clearing members must hold some capital against individual positions and also capital against their share of the default fund. But other mutualized risks or exposures beyond the default fund are not capitalized, including upward adjustments of the default fund in stressed markets, capital assessments beyond the default fund, and the potential need to assume positions from a defaulted member. Everything about those potential events becomes easier, less risky, and more reliable when members are better capitalized.

--The incentives paper raises the issue of clearing member concentration and its relationship to the costs of clearing, including capital. Excessive concentration of clearing services also contributes to systemic risk. But we should be seeking ways to increase the number and diversity of FCMs offering client clearing without increasing the overall leverage in the system. Given the dominance and significance of a small number of large bank FCMs, we should especially not be taking steps that could reduce the capitalization of these institutions. Instead, we should be

ensuring that they are as strong and solvent as possible, for example by ensuring that clearing activity makes a strong contribution to G-SIB surcharges.

--The paper on clearinghouse resolution was full of tactical details, but I wished that it had taken a more strategic approach to examining possible contradictions within the three stated goals of CCP resolution in the BIS resolution guidance. These goals are maintaining CCP function, protecting taxpayers, and maintaining financial stability. In a situation where CCP recovery efforts have failed, probably multiple times, with a resulting loss of market confidence, these objectives may come into conflict and raise difficult questions. It would be beneficial to make clear answers to those questions in advance.

Reading between the lines the paper implies that it will be challenging to actually use CCP equity in a highly stressed resolution-type situation. There are significant advantages to pre-funding such "skin in the game" through retained earnings during times when CCP valuations are high. For example, CME, with a market capitalization of $65 billion returns appears to pay almost all of its operating income out to shareholders – about $2 billion annually. CME's default fund currently stands at $8.3 billion. Over multiple years it seems that retained earnings could make a meaningful contribution to the default fund while still permitting strong levels of dividends.

--My final thought is not directly addressed in the papers we are reviewing, but it seems to me critical in all of them, and that is regulatory stress testing. Initial margin will always be the most important element of loss absorption in an unexpected situation. If cleared margin is set in a truly robust and counter-cyclical manner many other questions will be much less pressing. It did concern me that we heard prominent clearing members in this morning's panel and our last meeting raise questions about CCP margin model calibration.

Regulatory stress testing should be a key mechanism for ensuring we get margin right. As we all know, the CFTC is under-resourced, and within those resource limitations staff have been doing a great job standing up operational capacity to stress test CCPs down to position level. Now that we have that capacity, and several years of experience in running stress tests, we should think about how to use stress tests to explore a greater and more challenging range of stress scenarios. CFTC tests so far have found adequate resources, but there is a growing outside academic literature that raises concerns about issues ranging from a breakdown in correlation assumptions to network effects on losses. The CFTC should work to incorporate these concerns in future stress tests, and engage with clearing members to ensure that member concerns about margin models are addressed. In addition, the FSB paper on CCP resolution paper calls for identifying potential loss scenarios that may lead to resolution. This suggests a role for reverse stress testing.