Fourth Annual Joint Conference of the Deutsche Bundesbank, European Central Bank and Federal Reserve Bank of Chicago on CCP Risk Management

Summary of proceedings

Introduction

On **22 March 2022** the European Central Bank (ECB) hosted the fourth annual joint conference of the Deutsche Bundesbank, the ECB and the Federal Reserve Bank of Chicago on CCP Risk Management. In light of the ongoing Covid-19 pandemic, this year's conference was held virtually. The event, by invitation only and held under Chatham House Rules, brought together participants from industry, regulatory bodies and academia. The programme and relevant recordings can be found here.

Fabio Panetta, Member of the Executive Board of the ECB, opened the conference with a welcome address entitled "Building a robust and diversified clearing ecosystem". His remarks were followed by two panel debates and a fireside chat, as summarised below.

1 Panel 1: Extending central clearing

The panel focused on developments in traditional and emerging models of clearing. This discussion was moderated by the Federal Reserve Bank of Chicago.

Prior to the panel discussion, participants gave brief remarks on the invasion of Ukraine. Against the backdrop of the geopolitical situation, panellists further highlighted the responsibility CCPs have to foster confidence in markets and contribute to a robust clearing ecosystem that reduces financial risk. Panellists representing various institutions including CCPs discussed their continued monitoring of market exposures to Russia and potential cyberattacks, as well as other actions taken in response to the unfolding situation. They noted that recent geopolitical events and related sanctions have led CCPs and market participants to reduce market exposures to Russia. One CCP had relatively low volumes of Russian-related derivatives prior to the conflict and took steps to cease trading equity derivatives on products based on Russian assets. For its part, another CCP also suspended the extension of services to Russia. The necessary close-outs were managed and liquidated easily although most positions were relatively small. One clearing member stressed the difficulty involved in managing positions held on behalf of its clients and determining the default status of derivative contracts tied up in frozen accounts. Participants concurred that suspensions of trading can pose unwanted consequences for CCPs. They noted the importance of keeping markets open for price formation and to allow CCP models to perform. They concluded that geopolitical events have significant implications for the orderly functioning of markets.

The panel next turned to a discussion on developments in the clearing ecosystem, including margin procyclicality and its implications for financial stability. Some speakers agreed that CCPs must continue to provide access and transparency to market participants and regulators during periods of market volatility. They pointed to anti-procyclicality features of CCP initial margin models as key to dampening the impact of market stress. Recent volatility in energy and gas markets have led to increases in initial margin requirements with some observers advocating for the temporary release of CCPs' anti-procyclicality margin buffers to assist clearing members in meeting margin calls. One panellist contended that even if margin swings are ultimately very pronounced and procyclical, margin calls should be met in order not to compromise CCP risk management and rulebooks. Some panellists expressed the view that it is not sufficient to have US and Europe set separate rules with regard to requirements for the margin period of risk (MPOR) and anti-procyclicality measures. They noted that coordination and consistency across jurisdictions is key.

The conversation then shifted to renewed efforts to extend central clearing to new asset classes and markets. Following the Covid-19 volatility crisis of March 2020, the consensus was that the reforms implemented since 2008 withstood the recent shocks well, although heightened access of banks to liquidity through central bank financing played a key role. One panellist noted the importance of focusing on balancing credit and liquidity risks as an FMI and reducing risk in post trade operations. Before extending benefits of central clearing, it is important to consider whether products are clearable, and that technology and workflows (e.g. the "plumbing") are in place to accurately reflect trade status. FMIs should also consider how to deal with legal risk (e.g. for deliverable FX). Another panellist emphasised that if regulators wish to extend clearing obligations, they should consider whether an asset class is standardised and sufficiently liquid. Additionally, any extension of clearing obligations should strengthen the entire ecosystem and ensure consistency across multiple jurisdictions with little regional variation. For instance, one panellist noted some credit default swap (CDS) products are subject to the clearing requirement in the US but not in the EU.

The panel discussion pivoted to recent developments that are shaping the post-trade environment which include, but are not limited to, regulatory policy, recent changes in technology and the cost of collateral. It remains unclear in what direction these forces are moving. A global clearing system could benefit from alternative clearing options and solutions. The focus on clearing as an ecosystem emphasises the need for cooperation and coordination among clearing members and CCPs.

Regarding the extension of access to clearing, one CCP remarked that it has two main channels: direct membership and sponsored membership, the latter still in its infancy but growing. Panellists discussed how a set of different access models is necessary to make clearing available for a variety of entities, in particular non-bank clients that seek access to cleared repo markets. New access models, more competition, and a broader choice of providers for clients could reduce concentration risk in clearing.

While discussing new access models, panellists touched on at least three points that are often made in CCP discussions and are worth emphasising. First, one panellist made the point that not every product is suitable for clearing and that it is important to have safeguards (e.g. robust reporting and oversight) for those products. Secondly, participants also discussed where margins can be deposited safely. There is a growing but slow trend of placing client cash with central banks, as well as securities with central bank securities depository services (where available and allowable). One panellist underscored the need for a reliable mechanism to change highly liquid securities into cash. Lastly, panellists stated that CCPs need to think about whether supervisors have the right dashboards, visibility, and tools for accurate risk assessments. Relatedly, speakers briefly discussed the optimal level for a CCP’s skin-in-the-game.

Turning to direct clearing models and retail access, panellists noted they have seen more retail participation in derivatives markets and the potential for transition to a side-by-side existence of intermediated and non-intermediated models. One potential benefit of non-intermediated models is the reduction of risk contagion to the broader financial ecosystem in the absence of clearing members or intermediaries. Other panellists viewed extending access to clearing through intermediated models as a strong risk mitigator for certain clients and products. Lastly, one panellist noted it is not obvious that these new models can scale in wholesale markets.

The panel concluded that a lot of questions regarding the future trajectory of the clearing space remain open. This insight should encourage all market participants to closely follow such discussions with a particular eye on the risk implications of new developments.

2 Fireside chat

The fireside chat centred on the European Securities and Markets Authority’s (ESMA) role in shaping the future clearing landscape. The European Market Infrastructure Regulation (EMIR) provides for a robust and complex rulebook, which leaves some flexibility with respect to supervisory practices and approaches, in particular to cater to local features of cleared markets and different profiles of CCPs. Within this context, ESMA is tasked with promoting supervisory convergence in the EU, ensuring a level playing field for CCPs and fostering supervisory cooperation between ESMA and national competent authorities designated under EMIR. Supervisory convergence is crucial under both business-as-usual and crisis scenarios. In the current crisis situation following the invasion of Ukraine which triggered high volatility in energy markets, a consistent and timely information-sharing and coordination across all CCP supervisors is of utmost importance to ensure the continued resilience of EU CCPs throughout the exceptional stress.

With reference to the topics of the two panels, the discussion in the fireside chat touched on the forces such as new products, emerging technologies and climate change, that will shape the future clearing landscape. The fact that ESMA’s focus always relies on the risk perspective when assessing current and upcoming developments in clearing markets was emphasised. The increased demand for clearing of virtual currencies, digital assets and related indices was also noted, together with the need to correctly identify risks that these new types of products bring to the clearing space. The current crisis situation also brought to light that some additional safeguards for non-financial instruments would be warranted given their implication for the real economy and therefore financial markets. In particular, there is increased focus on spot commodity markets these days. There was some ambiguity as to whether spot commodity products would also be captured by EMIR. ESMA has previously clarified in a Q&A that CCPs licensed under EMIR for financial instruments would also need to be authorised for spot commodity products under EMIR prior to providing clearing services for those products. It was noted that it could be desirable to add this clarification directly in EMIR. Recent trends in market consolidation constitute another important development, following several mergers and acquisitions across the European trade and post-trade space. This development will be subject to increased scrutiny by ESMA and national competent authorities, with cooperation between authorities being crucial to capture potential risks arising from such consolidation.

Further elaborating on the risk perspective of ESMA, the discussion covered initial margin procyclicality. The consultation for the global report on margining practices during the March 2020 turmoil closed shortly before the conference. It was agreed that regulators need to strike a balance between ensuring the robustness of CCPs and therefore requiring them to call additional margin when needed, while also considering liquidity risks for the clearing members and their clients who have to meet these margin calls, which may become challenging in periods of stress. A unique characteristic of EMIR is that it requires CCPs to have anti-procyclicality tools in place and offers different options for CCPs to comply with this requirement. The Covid-19 pandemic, however, brought to light some deficiencies in CCPs' approaches, and the current market volatility triggered further reflections with respect to procyclicality in other product segments. In the EU, ESMA is at the forefront of establishing and steering regulatory requirements and expectations with respect to CCP margining practices. ESMA had recently published a consultation paper on how relevant EU regulatory requirements could be enhanced with respect to CCP anti-procyclicality approaches, and to ensure some baseline consistency across EU CCPs. ESMA aims to increase transparency and predictability of the deployed tools as well as to enhance governance and justification processes, while still leaving enough flexibility for CCPs to tailor their approaches to their specific risk profiles. The recent market volatility triggered by the geopolitical tensions prompted some further reflections at ESMA that would also be considered for the finalisation of the ESMA paper. At the same time, regarding certain aspects of CCP anti-procyclicality requirements such as public disclosure, ESMA would propose to wait for the outcome of the global work on margining practices, in particular to facilitate the consistency between relevant EU and international standards.

In closing the fireside chat, ESMA's upcoming tasks were discussed. It was mentioned that ESMA had recently launched a call for evidence for a CCP climate risk stress test, with market participants strongly encouraged to respond. Further, the European Commission is currently developing a proposal to revise EMIR, and ESMA sees scope for refinement of the supervisory system for both CCPs based in the EU and third-countries, including enhancement of the interplay and cooperation between different supervisory authorities. It was concluded that there are many factors influencing central clearing that are not only economic and macrofinancial in nature, but also environmental and technological. On top of these factors, an intensive rule-making process is ongoing, including the aforementioned EMIR revisions in Europe and margin discussions at global level. In view of the complexity of new developments in central clearing, the need for good cooperation and open dialogue was emphasised.

3 Panel 2: Climate change risks in financial markets

The panel addressed climate change risks in financial markets and was moderated by the Deutsche Bundesbank. The panel debate focused on financial market infrastructures (FMIs), notably CCPs and was structured along the three following areas: (1) scope of climate change risks, (2) climate risk analysis and (3) outlook.

There was consensus among panellists that the importance of climate change risks has been growing and has become a top priority on the agenda of policy makers, regulators and various industry stakeholders. Climate change risks are also being more seriously considered by CCPs who are eager to effectively address this topic in the future. Speakers noted that the developments in recent years clearly demonstrate that there are more extreme weather events, occurring at progressively shorter intervals. In the light of possible climate change impacts on business operations, business continuity planning, including geographical diversification of operational locations, becomes increasingly relevant for CCPs in order to ensure the smooth functioning of their main business services. When looking at the current volatility in the energy market, which could also be seen as an indication for future challenges stemming from climate change, panellists reported that some market participants (especially energy firms) have been facing liquidity problems due to higher margin requirements triggered by high volatility. For energy firms in particular, it is challenging to access additional liquidity to serve rising margin requirements compared to banks or other financial institutions. Furthermore, energy firms are less familiar with CCP processes and might therefore be less prepared for CCPs' requests for additional collateral, in particular on an intraday basis. One panellist suggested as a possible solution that educating clients on how the margining process works could help ensure that clients are both better prepared and less likely to suffer from liquidity squeezes in the future. In any case, the recent market volatility in the energy segment shows that a cooperative effort encompassing all actors in the ecosystem is warranted to respond to the challenges of climate change risks.

When dealing with climate change risks, CCPs could also assist the transition to a low carbon environment, for instance, through their product offering. Besides this, politics and regulation also play a decisive role when referring to transitional risks, since regulators' actions can have a significant impact on emissions, energy and other markets. Changes in caps for emission trading systems or the current discussions about voluntary carbon markets were mentioned as recent examples for relevant policy actions. In the past, politicians' statements on e.g. the nuclear and coal phase-out in Germany, had a direct impact on financial markets. Conclusively, it was noted that all CCPs, not only commodity CCPs, are affected by climate change risks but commodity CCPs might still face higher immediate impacts than other CCPs. Therefore, commodity CCPs are somewhat more advanced on climate change risks due to their cleared product portfolio and consider certain climate change risks in their stress test models today.

Subsequently, panellists discussed how climate change risks could be analysed, and how they could be integrated into the existing risk management framework. The implications for CCPs and their business models also need to be analysed properly as well as ensuring that climate change risks are adequately reflected in stress tests. So far, speakers noted that there is no common understanding and definition of the transmission channels and related modelling of climate change risks for CCPs. In addition, before climate change risks can be integrated into stress tests, CCPs should fully understand to what extent their clearing members are exposed to climate change risks e.g. in the commodity market and which implications such risks entail. There was general consensus that risk management frameworks have continuously evolved and are generally able to capture new sources of credit, market, liquidity or operational risks as a result of climate change. Consequently, according to the panellists there is no need to manage climate change as an individual risk type but it should rather be integrated into current risk management frameworks under the existing stress tests. It was argued that most CCP stress tests have a short-term perspective since the main objective is to ensure availability of adequate financial resources in the event of a default. However, such a short-term perspective cannot identify certain long-term aspects which need to be explored going forward. Panellists considered the main obstacle is insufficient historical data , which does not reflect the growing number of extreme weather events and new policy actions. Such events and policy actions can be difficult to predict, and they may require regime switches in modelling. In addition to these aspects, the design of extreme but plausible scenarios is also challenging, as climate change risks would need to be taken into account without exaggerating the level of conservativeness but still ensuring sufficient resilience. The Network for Greening the Financial System (NGFS) has developed general climate change scenarios which could also provide a good starting point for scenario generation for CCPs' risk management.

To conclude, panellists gave an outlook on the necessary efforts to tackle climate change risks. Moreover, panellists responded to a question on whether additional supervisory guidance is needed. While the current activities with respect to ESMA's call for evidence were acknowledged as a positive step in the right direction, further work and better exchange with industry, especially at international level, is still needed. Since climate change risks cannot be considered a national phenomenon, a global approach is crucial for successful risk management. Alongside supervisory guidance, harmonised disclosure and transparency requirements on climate change risks and the availability of the respective qualitative data will be important measures to inform CCPs' risk management practices for climate change risks. The most pressing mission in the years to come is raising awareness on climate change risks and their medium- and long-term implications for all financial markets and market participants. Even though climate change risks entail multiple risks for CCPs, it was acknowledged that addressing such risks offers opportunities for CCPs' business models, at least if CCPs move early enough, to enable green transition. With respect to regulatory guidance, the panel concluded that while climate change risks could be covered by the CPMI IOSCO Principles for financial market infrastructures (PFMI), the requirements remain very high level. Hence, there could be a need to reflect on whether it would be warranted to provide additional guidance for climate change in the context of the PFMI.

Conclusion

Burkhard Balz, Member of the Executive Board of the Deutsche Bundesbank, closed the conference with remarks on "Challenges for CCPs in the face of amid turbulent financial markets".