Vanderbilt Law Review

Volume 70
Issue 7 *En Banc*

Article 22

2017

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Recommended Citation

Dermot Turing, What Do We Do with Troubled CCPs, 70 *Vanderbilt Law Review* (2024)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol70/iss7/22

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What Do We Do with Troubled CCPs?

*Dermot Turing**

A current problem in relation to the regulation of financial market infrastructures is how to deal with them when they experience financial difficulties.[1] By far the most difficult type of infrastructure, from the perspective of policy formation, is the clearinghouse or central counterparty ("CCP"). Unlike other types of infrastructures, CCPs take on counterparty risk, which makes them seem—superficially at least—similar to banks and broker-dealers, which also assume counterparty risk on similar products.

That comparability has allowed policymakers to fall into a trap and assume that CCPs that are in financial difficulty could be "resolved" like an ailing bank, or at least that the toolkit for ailing banks might have useful things in it that could work for a troubled CCP. That is, unfortunately, wrong.

The principal reason for the error is that CCPs are not banks.[2] The purpose and methodology of resolution should differ between CCPs and banks. Banks have depositors who need to be protected. Bank resolutions are thus built on the premise that a "good bank" containing the depositors' and sound loan assets can be pulled out of the wreck, and even that form of intervention may not be needed if bondholders and other junior creditors can be "bailed-in" (i.e. required to forgo part or all of their claims). CCPs have no depositors, no loan assets, and no junior creditors. So, neither bail-in nor a good-bad split is a feasible

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1. *See, e.g.*, FINANCIAL STABILITY BOARD, GUIDANCE ON CENTRAL COUNTERPARTY RESOLUTION AND RESOLUTION PLANNING: CONSULTATIVE DOCUMENT (2017), http://www.fsb.org/wp-content/uploads/Guidance-on-Central-Counterparty-Resolution-and-Resolution-Planning.pdf [https://perma.cc/58LU-BFVQ]; *Commission Proposal for a Regulation of the European Parliament and of the Council on a Framework for the Recovery and Resolution of Central Counterparties and Amending Regulations (EU) No 1095/2010, (EU) No 648/2012, and (EU) 2015/2365*, COM (2016) 856 final (Nov. 28, 2016).

2. *See* Robert T. Cox & Robert S. Steigerwald, *A CCP is a CCP is a CCP* (Fed. Reserve Bank of Chi., PDP 2017-01, 2017), https://www.chicagofed.org/publications/policy-discussion-papers/2017/pdp-1 [https://perma.cc/S5LM-4R3H].

option. In this context, it is perhaps difficult to imagine what "resolution" is meant to achieve in the case of a CCP.

In fact, the expressed objective of CCP "resolution" is the continuation of clearing.[3] Clearing, perceived at the time of the financial crisis to be a universal good, is being made mandatory;[4] if CCPs were able to fail completely, market users might be unable to clear. So, in practical terms, resolution is actually a form of rescue. The one feasible tool for reinstatement of a CCP is "variation margin gains haircutting," which is a form of bail-in of the entitlements of CCP participants whose profits on cleared contracts are retained by the CCP. These sums, which are paid by lossmaking participants, keep the CCP afloat, possibly indefinitely. Meanwhile, clearing goes on just as before the event that almost caused the CCP to go under.

A further question that distinguishes banks from CCPs is who bears the cost of resolution. For banks, the shareholders, bondholders and wholesale clients bear the brunt. CCPs have shareholders, but shareholders are not obliged to have substantial "skin in the game"[5] (see charts below,[6] which use U.K. CCPs as examples since EU rules set a minimum level of skin in the game). Consequently, users bear the brunt when it comes to CCPs.

That may not be wrong in principle, but the following comments might be made:

1. Clearing members already pay to keep CCPs afloat in the sense that they must collateralise their own positions and provide contributions to the CCP's default fund. They may also be liable for a third line of defense, commonly called assessment, which obliges them to pay further sums when the CCP passes round the hat. The charts below show how big these amounts are relative to shareholders' resources.
2. It is not obvious, in policy terms, why CCPs' owners (those who reap the rents from the mandatory clearing operations of CCPs) should not have substantial skin in the game. Users are not necessarily the same persons, since CCPs are not

3. *See* FINANCIAL STABILITY BOARD, *supra* note 1, at 3.

4. *See OECD and the G20: Pittsburgh, United States 2009*, ORG. FOR ECON. CO-OPERATION & DEV., https://www.oecd.org/g20/summits/pittsburgh/ [https://perma.cc/26A5-M354] (last visited Aug. 11, 2017).

5. Christopher Perkins et al., *Central Counterparties Need Thicker Skins*, 4 J. FIN. MKT. INFRASTRUCTURES 55, 55–63 (2016).

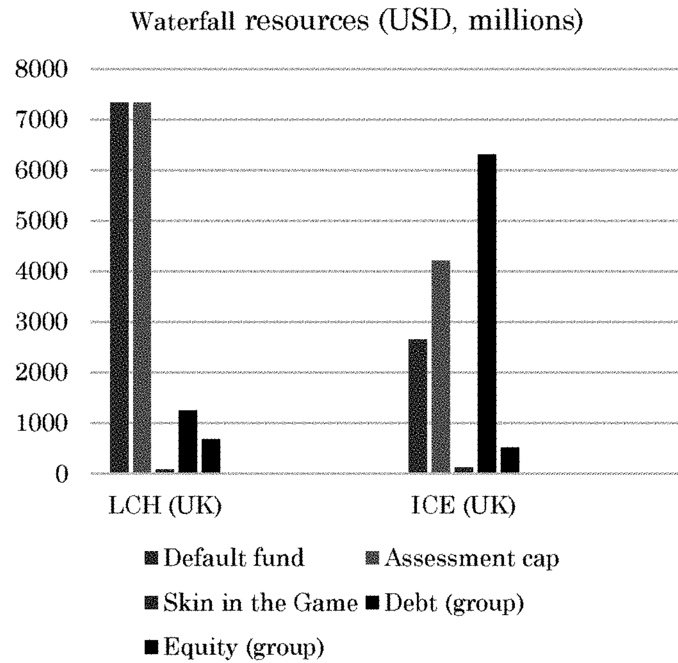
6. *CCP Disclosures*, LCH.COM, http://www.lch.com/rules-regulations/cpmi-iosco [https://perma.cc/FK6U-VWTD] (last visited Oct. 6, 2017); *ICE Clear Europe Regulation*, THEICE.COM, https://www.theice.com/clear-europe/regulation [https://perma.cc/DJN8-3RDF] (last visited Oct. 6, 2017).

mutually owned.[7] It may also be noted that the risk and business models used by a CCP will typically be controlled by the owners—through the management team they select—and not by the users, although users can usually make recommendations and influence the risk model. It is model failure that will cause CCP failure, and so owners' decisions can affect whether users are at risk.

3. It would appear to follow that users ought to be allowed some kind of escape valve so they can be sure they are not writing a blank check to keep a failed CCP (and a failed risk model) afloat indefinitely. Clearing members ought to be allowed to put a CCP with a failed risk model into regular bankruptcy, rather than be forced to endure ongoing "resolution." This is a question of who is in control of resolution decisionmaking, which would—as policy is currently being framed—be a regulatory agency.
4. Another option to consider would be to relax the obligation to clear products whenever a CCP clearing that product class has failed (including near misses, such as exhaustion of the default fund). This would allow the market to decide whether the failed CCP should live or die; and if it is to live, it could be revived with a new risk model which is more fit-for-purpose than the old one.

In sum, regulatory policy for troubled CCPs is itself troubled. Further thinking is needed before implementation; and in Europe, where draft legislation is in motion, a pause is needed.

7. *See* Robert T. Cox & Robert S. Steigerwald, *"Incomplete Demutualization" and Financial Market Infrastructure: Central Counterparty Ownership and Governance After the Crisis of 2008-9,* J. FIN. MKT. INFRASTRUCTURES 25, 25–38 (2016).



Who pays?	LCH (UK) USD millions
Defaulter (after initial margin, average of top 5 contributions to default fund)	235
Investors	77
Survivors (default fund + assessment liability, excluding defaulter)	14,206
Taxpayers	0