Opinion **Clearing and settlement**

# Banks are right to say that clearing houses are ripe for reform

There are concerns about what would happen in the event of a big default or shock

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Traders on the former financial floor of CME Group's Chicago Board of Trade © Bloomberg

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Big banks do not usually gang up to demand more financial regulation, least of all with asset managers in tow. But this week some Wall Street banks are doing precisely that — albeit not in relation to their own operations, but to the clearing platform where they settle trades.

Today nine financial giants — Allianz, BlackRock, Citi, Goldman Sachs, Société Générale, JPMorgan, State Street, T Rowe Price and Vanguard — release a joint statement calling for the reform of central counterparty clearing groups (CCPs).

They want regulators to impose better default buffers, disclosure and corporate governance on these clearing houses, whose ranks are dominated by the Chicago Mercantile Exchange, London Clearing House, Eurex and Intercontinental Exchange.

“Although regulators have made progress in enhancing a minimum level of CCPs’ pre-funded resources and setting risk management standards [to protect against default], several gaps in CCP resilience remain,” they warn. They note that it is “imperative that regulators take steps to address [a] misalignment of incentives”. Or, in plain English, the banks and asset managers fear that clearing houses pose systemic risks — and nobody is paying attention.

Are they right? Unsurprisingly, officials argue not and point out that they have already improved their risk management procedures in recent years to cope with foreseeable shocks. LCH, for example, collects a buffer of funds from its members that supposedly could absorb the default of its two biggest financial players.

CCP officials also argue that it is unfair to impose tougher regulatory standards since clearing houses (unlike banks or asset managers) are not in the business of taking proprietary risks. Indeed, they view the statement as just an attempt by brokers and banks to offload the cost of sensible risk management processes.

There may be a grain of truth in this: self-interest is certainly a factor here, but regulators need to heed the call nevertheless. So do investors. For the letter is entirely correct to point out that the current status quo around clearing houses is worrying. The nine financial groups are even more justified in feeling frustrated that regulators have hitherto done so little to change it.

This matters. Until 2008, many derivatives and repurchase (or "repo") trades were settled bilaterally without using clearing houses. However, the G20 governments pledged to change this system after the 2008 crisis, when bilateral trading had sparked panic. Most derivatives were thus pushed into clearing houses and many repo trades migrated there too, in the name of "safety".

But there was a catch: even as the trading risks were being concentrated into the clearing houses, regulators did not spell out what would happen if a CCP itself suddenly collapsed. What has further muddied the waters is that the clearing houses are no longer member-owned utilities, but have been turned into for-profit entities, owned by exchanges.

CCP officials say this does not matter, since it is unthinkable that a clearing house might collapse. Perhaps so. But three small(ish) clearing houses have already failed in the past 50 years, because of member defaults. And what has recently concentrated minds is that when a small trader handling Nordic power contracts collapsed last year this wiped out two-thirds of the Nasdaq clearing house's default fund.

Unsurprisingly, bankers are worried about what would happen with a big default, or a shock such as cyber attack. "If a CCP could not withstand the failure of a clearing member that was part of a large and complex financial group, it would become a devastating mechanism for transmitting distress across the financial system," as the Systemic Risk Council, chaired by former Bank of England deputy governor Paul Tucker, spelt out in a trenchant letter to the Financial Stability Board demanding action.

Sadly, regulators seem unlikely to act swiftly. One problem is reform exhaustion. Another is tension between regulatory agencies. Worse still, the operations of clearing houses are so arcane that there is little political pressure for action.

But regulators cannot afford to keep sweeping the problem under the carpet. They urgently need to launch a debate, not just about the risks, but some of the numerous possible solutions mooted in the letter and SRC paper. (One idea is that clearing houses should issue "bail-in" bonds to strengthen their buffers.) Otherwise, we will be left contemplating the following irony: a measure introduced to make the system safer is now creating new risks. Welcome to the era of unintended consequences.

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