For release on delivery
1:00 p.m. EDT
June 4, 1993

Clearance and Settlement of Derivative Products

Remarks by Susan M. Phillips

Member, Board of Governors of the Federal Reserve System

FIA New York Operations Division Workshop

June 4, 1993

I am pleased to be able to participate in this interesting and timely program. I would like to take this opportunity to share with you my thoughts about several aspects of financial system risk management: first, appropriate public policies toward clearance and settlement of derivatives, both those traded on exchanges and in over-the-counter (OTC) markets, and, second, some of the Board's thinking in coming to its recent decision to delegate margin authority for stock index futures to the Commodity Futures Trading Commission.

You might wonder what specifically is the Federal Reserve Board's policy interest in clearance and settlement systems, which some may consider a technical or legal subject. The Board's interest stems from its broad responsibility, as the nation's central bank, for maintaining financial market stability and containing potential systemic risks. Because weaknesses in clearance and settlement systems are a potential source of systemic problems, the Board has examined closely the design and operation of clearance and settlement systems for financial instruments, including derivative instruments.

In recent years the Board's interest in clearing arrangements for derivatives has been reinforced by rapid changes in market structure and by new responsibilities created by legislation. As you no doubt are aware, the OTC financial derivatives markets have grown rapidly since the mid-1980s, and banking organizations for which the Federal Reserve has regulatory responsibility are among the most active players. Furthermore, after a multi-year debate on the regulation of stock index futures margins, Congress passed the Futures Trading Practices Act of 1992, which among other things assigned this regulatory authority to the Federal Reserve.

As a general matter, the Federal Reserve believes that the sound and efficient operation of clearance and settlement systems for derivatives is, and must remain, the primary responsibility of the private sector. That is, public policy interests in such systems are best served by developing broad and flexible standards and by allowing private market participants latitude to determine how best to meet those standards, rather than by attempts to micro-manage through regulation. In the remainder of my remarks today, I will try to illustrate this philosophy by discussing the Federal Reserve's policies regarding the clearance and settlement of OTC derivatives and appropriate levels of margin for stock index futures.

Policies Toward Clearance and Settlement of OTC Derivatives

To date, banks and other intermediaries or "dealers" in OTC derivatives have taken a fundamentally different approach to the management of counterparty credit and liquidity risks than the approach utilized for exchange-traded products. No clearing house yet has been formed to net OTC derivatives contracts multilaterally by substituting itself as seller to every buyer and buyer to every seller. Nor have the practices of daily payment of variation margin and posting of performance bond collateral been widely adopted. Rather, individual counterparties manage risks bilaterally. Counterparties are selected on the basis of credit ratings and evaluations. Credit exposures are carefully measured and controlled. Claims and obligations arising from multiple contracts between two counterparties typically are netted bilaterally, usually through a standardized agreement developed by the International Swap Dealers Association (ISDA).

Several years ago the Federal Reserve and other central banks undertook a thorough study of clearance and settlement arrangements for payments and for foreign exchange contracts. The study included a detailed analysis of proposals to create clearing houses for forward foreign exchange contracts. The analysis was summarized in the Report of the Committee on Interbank Netting Schemes (Lamfalussy Report), which was published by the Bank for International Settlements (BIS) in November 1990. The central conclusion of that report was that netting arrangements--both bilateral and multilateral--have the potential to reduce systemic risks, if properly structured. The Report set out minimum standards for the design and operation of cross-border and multicurrency netting schemes, which are broadly applicable to payment systems and to clearing houses for foreign exchange forward contracts or other OTC derivatives. These standards address the legal enforceability, transparency, and operational reliability of both bilateral and multilateral netting arrangements. They also address the credit and liquidity safeguards that the central counterparty (clearing house) in a multilateral system must employ to ensure its financial integrity.

The standards are broad statements of principle rather than an attempt to identify best practices or to endorse or prescribe specific risk control mechanisms. For example, with respect to the credit and liquidity safeguards that a clearing house must impose, the standards simply indicate that limits must be placed on the maximum level of credit exposure to each participant and that sufficient liquidity resources must be available to ensure timely completion of settlement in the event of the failure of the single largest participant. I would note that even this minimum standard poses a challenge that may not be met by all existing clearance and settlement systems for derivative instruments.

The standards are stated in general terms partly because of concerns about moral hazard. If market participants come to see central banks as taking direct responsibility for the stability of netting or settlement systems, their incentives to manage risks prudently would be undermined. The Lamfalussy Report emphasized that the minimum standards are not intended to diminish the responsibility of market participants for ensuring that netting systems have adequate credit, liquidity, and operational safeguards.

The decision to avoid endorsing a specific approach to risk management also reflected the Lamfalussy Committee's conclusion that quite different designs of clearing systems for derivatives were feasible. In particular, the Committee studied carefully the relative merits of centralized and decentralized risk management systems for a clearing house. The Committee recognized the proven effectiveness of the centralized, collateral-based systems employed by futures and options clearing houses. But it concluded that a decentralized approach also is feasible. Such an approach seeks to preserve incentives for bilateral credit risk management by allocating losses to participants on the basis of their bilateral dealings with a failed participant. The Report concluded, however, that the system's liquidity risks probably would need to be managed centrally. Bankers currently working to develop clearing houses for spot and forward foreign exchange contracts are, in fact, pursuing one type of decentralized credit risk management.

Rather than seeking to force the evolution of clearing methods for OTC derivatives along particular lines, central banks and banking regulators have focused on refining capital requirements to provide appropriate incentives for market participants to adopt risk-reducing innovations and on reducing uncertainty about the legal enforceability of netting agreements. With respect to capital requirements, last December the Federal Reserve revised its risk-based capital requirements for banking organizations for certain low-risk collateralized transactions such as securities lending. These revisions, which apply to OTC derivatives exposures, recognize the risk-reducing effects of collateral and margining procedures. Specifically, capital requirements were eliminated for credit exposures that are collateralized by cash or government securities, provided that the collateral value is adjusted each day to exceed the exposure by some positive margin. The Board chose not to specify minimum margin levels but expects banking organizations to maintain prudent levels, taking into account the volatility of the exposures and of the collateral values.

The Federal Reserve and other banking supervisors in the G-10 countries also have proposed to revise risk-based capital requirements to provide stronger incentives for the development and utilization of sound netting arrangements for OTC derivatives. The existing Basle Capital Accord provides only limited recognition of the potential for netting to reduce credit risks. Among bilateral netting agreements, only one particular restrictive form is recognized--that is, bilateral netting by novation of foreign exchange obligations for the same currency and value date. With respect to multilateral netting arrangements, the existing Accord recognizes the risk-reducing effects of futures-style margining. Banks are not required to maintain capital to support credit exposures to clearing houses that employ such safeguards.

The new G-10 proposal, which was issued for public comment at the end of April, would among other things expand recognition of bilateral netting arrangements for capital adequacy purposes to encompass all such arrangements that are effective under relevant laws and that comply with the other minimum standards of the Lamfalussy Report. Furthermore, the proposal indicated a willingness to recognize multilateral netting arrangements that utilize a decentralized risk management model. However, the development of concrete proposals for capital treatment of such credit exposures was deferred until the details of the developing arrangements become clearer.

The Lamfalussy standards emphasize the critical importance of the legal enforceability of netting agreements. If a counterparty measures its credit exposure on a net basis but the netting agreement is not enforceable, the true exposure is the gross exposure. The counterparty thus could face losses and liquidity pressures far larger than expected and, quite possibly, larger than could readily be absorbed. In some foreign jurisdictions, doubts about the legal enforceability of netting agreements remain a significant impediment to their use. By contrast, a series of legislative changes in the United States has provided substantial legal certainty regarding the enforceability of such contracts.

The latest change was a far-reaching provision of the FDIC Improvement Act (FDICIA). This provision validated under U.S. law all netting contracts between and among depository institutions, securities broker-dealers, and futures commission merchants. Furthermore, it authorized the Federal Reserve Board to broaden the coverage to other financial institutions if it determines that doing so is appropriate to reduce systemic risk. In early May, the Board issued a proposed rule that would broaden the definition of financial institution to include all legal entities that are large-scale dealers in the OTC derivatives markets. Implementation of this proposal would eliminate uncertainty about the legal enforceability of netting agreements between certain affiliates of broker/dealers and insurance companies that are active dealers in the OTC derivatives market and banks and other entities that already meet the statutory definition of financial institution.

The Federal Reserve also has sought to ensure that U.S. commodities laws do not impose unnecessary impediments to risk-reduction capabilities in the OTC derivatives markets. In a letter supporting the CFTC's proposal to exempt OTC derivatives from certain provisions of the Commodity Exchange Act, the Board stressed the importance of the elimination of restrictions in previous policy statements on bilateral credit enhancements, such as collateral or margining arrangements. The Board also urged the Commission to permit the development by market participants of clearing house arrangements for OTC derivatives.

Although the Commission's final action stopped short of permitting a clearing house for OTC derivatives, the analysis of the potential public benefits of a clearing house that accompanied the final rule appears broadly consistent with the analysis and conclusions of the Lamfalussy Report. Specifically, the Commission indicated that the design and operation of clearing facilities should be driven by the needs and desires of market participants, clearly a view shared by the Federal Reserve Board. If market participants come forward with such a proposal, the Commission's exemptive authority provides it the flexibility to design an appropriate regulatory framework.

I should note the Board has never suggested that an OTC derivatives clearing house be wholly unsupervised. There are potential systemic risk concerns related to such a facility. Indeed, the Governors of the G-10 central banks (including the Federal Reserve) have endorsed a principle, set out in the Lamfalussy Report, that an OTC derivatives clearing house that conducts settlements in foreign currencies or has foreign bank participants should be subject to official oversight. The Lamfalussy minimum standards are intended as a starting point for analyzing the implications of a clearing house's design and operation for systemic risks to financial markets and market participants, both in the United States and abroad.

Policies Regarding Appropriate Margin Levels for Stock Index Futures

The Board's philosophy of setting broad standards for clearance and settlement arrangements and leaving it to market participants to determine how best to meet these standards has also been applied in its decisions regarding the appropriate levels of margins on stock-index futures and options on futures. Under the Futures Trading Practices Act, primary responsibility for setting margin levels remains with the exchange and its clearing organization. But federal oversight of the process is established. Contract markets must file any rules establishing or changing levels of margin on such contracts with the Federal Reserve. The Board may at any time request a contract market to alter margin levels and, if the contract market fails to respond, the Board may direct it to alter margin levels. Such authority may also be delegated fully or in part to the CFTC.

The statute indicates that the Board's oversight authority is intended to ensure that margin levels are appropriate "to preserve the financial integrity of the contract market or its clearing system or to prevent systemic risk." The Board believes that this objective requires the exchange and its clearing system to implement a risk management system that can cover any losses and meet financial obligations in a timely manner in the event of a default by a large participant. This is, of course, the same broad standard the Board has applied in evaluating whether clearing systems for OTC derivatives and other financial instruments adequately contain potential systemic risks.

Margin requirements are a key financial safeguard in the risk management systems utilized by futures exchanges and their clearing entities. Nonetheless, other risk management tools are equally important to the financial integrity of a contract market. These tools include capital requirements for futures commission merchants, membership requirements for exchange and clearing members, audit and supervision capabilities, and the full range of safeguards employed by clearing organizations, especially the daily (and intraday) collection and payment of variation margin, loss-sharing arrangements with member firms, and the availability of bank credit lines.

These other components of exchange and clearing house risk management systems are critical because margins typically are not set (and for short positions simply cannot be set) to cover all potential future losses from extreme movements in prices. Rather, margins typically are intended to cover only 95 to 99 percent of price movements, based upon historical experience. Thus, price movements in excess of margin levels are expected but cannot be allowed to jeopardize the integrity of the contract market. The capital and liquidity of member firms typically must be sufficient to cover anticipated margin deficiencies. And if a member were to default on its contractual obligations, the risk management system employed by the contract market must be designed to ensure that such losses can be covered. The clearing organization must also have systems, procedures, and liquidity resources that allow it to meet its obligations to other participants in a timely fashion.

An assessment of the level of margins necessary to protect the financial integrity of the contract market and prevent systemic risk must take into account the strength of these other critical elements of the risk management system. In principle, a contract market with relatively stringent membership and capital requirements and sizable liquidity facilities may achieve an adequate degree of protection with relatively low levels of margin. At the other end of the spectrum, higher margins would be advisable for markets with less strict membership and capital requirements or smaller liquidity resources.

The CFTC is most familiar with and has the most comprehensive authority over these risk management systems, and, thus, is in the best position to make judgments about appropriate margin levels and to ensure that such levels are maintained. For this reason, in late March the Board delegated its authority over stock-index futures margins to the CFTC until further notice. The Board expects that the CFTC will review the appropriateness of margin levels in light of the statutory objective and the strength of the contract market's overall risk management system. The CFTC has agreed to report to the Board annually on its experience in reviewing such levels.

Conclusion

I hope that my remarks today provide you with a better understanding of the principles that underlie the Federal Reserve's efforts to strengthen clearance and settlement arrangements for derivative products. The private sector, with regulatory and central bank support and encouragement, has made significant progress in this area in recent years. I look forward to working with market participants and fellow regulators to achieve further improvements. Thank you.