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A "principled" approach to international guidance for central counterparties

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Following the 2007–08 financial crisis, the G20 agreed to implement a clearing mandate, requiring all standardized over-the-counter derivatives to be cleared through a central counterparty (CCP). The central role of CCPs in post-crisis financial markets has increased the interest of both national authorities and international standard setters in CCP regulation.

The Bank for International Settlements' Committee on Payments and Market Infrastructures (CPMI, previously named the Committee on Payment and Settlement Systems) and the International Organization of Securities Commissions (IOSCO) are the international standard-setting bodies for CCPs. In 2012, they published the *Principles for Financial Market Infrastructures* (PFMI), building on the *Recommendations for Central Counterparties* published in 2004 (CPMS-IOSCO, 2012, 2004). These documents provide an international set of standards for CCPs and their regulators to apply. CPMI-IOSCO published more granular guidance on the "Resilience of central counterparties (CCPs): Further guidance on the PFMI" in 2017 (CPMI-IOSCO, 2017).

Some have welcomed the granular guidance contained in "Resilience of central counterparties." In a comment letter on the draft guidance—which became the final guidance with few substantive changes—the Futures Industry Association and the International Swaps and Derivatives Association stated that "the additional granularity provided in this guidance will improve the governance structure of CCPs" (FIA et al., 2016, p. 1). Others have argued that the guidance is too detailed. According to the World Federation of Exchanges, "the proposed further guidance creates a more prescriptive set of risk management requirements for CCPs to follow. This is likely to compromise the effectiveness of the standards, and the ability of CCPs to operate effectively in the event of another financial crisis."[1]

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This article contributes to the ongoing debate over the appropriate level of granularity for international guidance on CCPs. I summarize the existing standard-setting frameworks and argue that international bodies should establish general standards for CCP regulation, leaving room for national authorities and the CCPs they oversee to determine how best to implement those standards. I suggest that the promulgation of general rather than granular standards best accords with the mandates of the international organizations involved. Further, I argue that, at the international level, general standards are superior to granular standards for guiding the behavior of CCPs and establishing best practices. To support my arguments, I draw on the extensive literature comparing the merits of rule- and principle-based regulatory frameworks.

Granularity and the mandates of standard-setting bodies

In this section, I argue that the international standard-setting bodies that address CCP regulation should promulgate general standards. I argue that, relative to a more granular approach, a more general framework best accords with the mandates of the relevant standard setters.

Mandates of international standard setters

There are three main international bodies that set standards for CCPs.

IOSCO is an international body of securities regulators that develops, implements, and promotes adherence to internationally recognized standards for securities regulation.

CPMI (formerly CPSS) is composed of senior officials of central banks from around the world. It makes recommendations about the safety and efficiency of payment, clearing, settlement, and related arrangements and serves as a forum for central bank cooperation in related oversight, policy, and operational matters. As noted earlier, these two bodies have published the *Principles for Financial Market Infrastructures*, as well as more granular guidance on the "Resilience of central counterparties."

The Financial Stability Board (FSB) includes representatives of governmental agencies and central banks, as well as international organizations including the Bank for International Settlements, the Basel Committee on Banking Supervision, CPMI, the International Association of Insurance Supervisors, the International Monetary Fund, and IOSCO. It seeks to "assess vulnerabilities affecting the global financial system and identify and review ... actions needed to address them" as well as promote "coordination and information exchange among authorities responsible for financial stability."[2] The FSB has published guidance on resolution for financial institutions in general, and CCPs in particular (Financial Stability Board, 2017, 2016, 2014).

The charters for the FSB and CPMI establish these organizations as standard-setting bodies, leaving implementation and granular regulation to national bodies. The FSB charter states that the FSB will "promote coordination and information exchange," "advise on and monitor best practices," and "coordinate the policy development work of the international standard setting bodies."[3] CPMI's mandate is to monitor and analyze developments in payments, clearing, and settlement, to serve as a forum for central bank cooperation, and to serve as a global standard setter.[4] Neither organization has the authority to promulgate legally binding rules. As CPMI's charter states, it "does not possess any formal supranational authority [and] relies on the commitment of its members to carry out its mandate."[5]

A framework composed of general standards appears to be the most consistent with the goals of monitoring, coordinating, and advising. General standards for CCPs provide ample scope to fulfill these objectives, while leaving room for national authorities to implement regulations tailored to their nations' specific circumstances.

Mandates of local regulators

The recognition that global financial markets require international coordination has led to the development of international standard-setting bodies. However, most CCP regulation takes place on a national level, through laws passed by national legislatures and implemented by national regulatory authorities. The power to implement and enforce financial regulation ultimately rests at a national level. An important aspect of this power is the ability to decide how specific and prescriptive to make a given regulation. Overly granular international guidance effectively takes this choice away from national regulators and locates it instead at the international level.

Even within the U.S., we can find cases of regulators exercising discretion in interpreting international guidance. For example, the PFMI recommend that CCPs hold sufficient resources to manage the default of the clearing member to which they have the largest exposure, a "Cover 1" standard. They recommend that systemically important CCPs have sufficient resources to manage the simultaneous default of the two clearing members to which they have the largest exposures, a "Cover 2" standard. While the U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC) require that Cover 2 standards be met with prefunded resources, the CFTC allows the use of both prefunded resources and assessment powers for calculating Cover 1.[6] The SEC requires that Cover 1 also be met with prefunded resources.

Rules versus principles

Regulatory frameworks can be divided into two broad categories: rules-based and principles-based. In this section, I draw insights from the literature on the relative merits of rules- and principles-based regulation into the appropriate granularity of international guidance on CCPs. Principles, like general standards, allow room for local variation and tailored implementations. Rules, like granular standards, impose more constraints and require greater uniformity. My reading of the literature comparing principles and rules suggests that international standards should look more like principles than rules, and consequently should avoid excessive granularity, as those concepts are defined in the literature.

Literature on rules- and principles-based regulatory frameworks

There is an extensive literature on the respective benefits of rules and principles in various regulatory contexts. Here, I provide an overview of this literature, which helps to guide the analysis of the appropriate level of granularity for international standards on CCP regulation and operation.

Both rules and principles can be either complex or simple and both can be either stringent or lax. They differ primarily in the level of detail they contain and in the amount of discretion left to those applying them. Rules tend to be specific and concrete, leaving limited room for discretion. Principles tend to be general and abstract, leaving significant room for discretion (Burgemeestre, Hulstijn, and Tan, 2009). For example, a regulation seeking to promote safe driving might prohibit "driving in excess of 55 miles per hour on expressways" if promulgated in the form of a rule, while it might prohibit "driving at an excessive speed" if promulgated as a principle (Kaplow, 1992, p. 560). In general, the content of rules is settled ex ante. Whether a given action complies with a principle is settled ex post.

The distinction between rules- and principles-based frameworks is not always clear cut. "Rules may become more principle-like through the addition of qualifications and exceptions, whereas principles may become more rule-like by the addition of best-practices and requirements" (Burgemeestre, Hulstijn, and Tan, 2009, p. 2).

Rules have several benefits relative to principles. In general, they are easier to enforce. Those subject to rules have an easier time determining how to comply with them (Kaplow, 1992). Since a rule specifies its content ahead of time and leaves limited room for discretion, those applying a rule have a relatively straightforward task once they have established the facts of a case. Rules also communicate their expectations to the firms or individuals facing them without the need for extensive interpretive guidance.

Rules allow authorities to enforce greater consistency across regulated entities, which may make regulations more difficult to evade. Explicit rules can help counter the "propensity of profit-seeking financial institutions to evade compliance by making use of regulatory gaps and of terms open to interpretation" (Mayntz, 2015, pp. 58–59). Increased granularity can "assist in the enactment of rules and [help] make certain that the rule-makers' intentions are realized" (Mayntz, 2015, p. 59). The evolution of bank capital regulation provides an example of the use of granular rules to prevent firms from evading compliance. "Bank capital regulation has evolved in an almost lockstep dialectical manner with regulatory capital arbitrage. Each enactment by policymakers of new capital rules has engendered new strategies by financial institutions to game those rules. This gives birth to a new generation of rules, as policymakers attempt to close loopholes" (Gerding, 2016, p. 358).

Rules-based frameworks have several disadvantages. A rules-based regulatory system can foster a box-checking mentality in which the letter but not the spirit of the rule is followed (Kaplow, 1992). Rules can be expensive to write and difficult to update. In financial markets, where conditions change quickly and the appropriate rule may vary based on the specifics of a given situation, these are significant drawbacks, leading some to argue that "financial markets are too fast-moving and complex to be regulated in a command-and-control manner" (Ford, 2010, p. 261).

Granular rules might reduce the financial system's resiliency. If granular rules lead to greater conformity in behavior among firms, then outcomes, including responses to financial shocks, will be more correlated. Thus, if granular rules have unintended consequences or encourage dangerous behavior, many players in a market may engage in that behavior at the same time, exacerbating any negative effects.

Principles, on the other hand, allow for flexibility. In a principles-based regulatory system, legislators or standard setters establish an outcome they wish to see achieved or a behavioral standard they wish firms to meet and then firms, overseen by their regulators, determine how they can best conform to the principle. If implemented well, principles-based regulation allows for a focus on substantive compliance since unnecessary box-checking exercises can be avoided. Broad principles leave room for experimentation and the diversification of regulatory regimes, while still holding all market infrastructures to a common standard. A broader, principles-based regulatory framework may also be able to avoid the model risk created by a narrowly tailored, rules-based framework.

Principles do have some drawbacks. Acquiring the legal advice necessary for compliance with general principles may be too costly for small firms, leading them to prefer rules (Black, Hopper, and Band, 2007). Principles can also be subject to regulatory mission creep—"increasing prescription, complexity and inaccessibility can occur if principles are elaborated in a multitude of mandatory or quasi-mandatory provisions" (Black, Hopper, and Band, 2007, p. 197).

The effective implementation of a principles-based regulatory system can only occur if several preconditions are met. Since principles-based regulation relies on firms to determine the means by which they will comply with regulatory principles, principles-based regulation requires active engagement between firms and regulators (Ford, 2010). Regulators must be independent and well-informed if they are to be able to effectively engage with and oversee firms' implementation of regulatory principles (Ford, 2010). They also must have the expertise and funding necessary for such active engagement. Regulators must communicate their objectives to firms; principles can lead to a lack of certainty for firms if they and their regulators do not come to a shared understanding of what the principles mean (Black, Hopper, and Band, 2007). Regulators must also make clear their enforcement policies. Ambiguous enforcement policies can lead firms to adopt "overly conservative courses of action" in the fear that to do otherwise will be considered noncompliance (Black, Hopper, and Band, 2007, p. 199).

Firms in principles-based regulatory systems must be able to explain to regulators how they are substantively complying with the established regulatory principles (Black, 2008). They must engage with regulators in good faith; regulators must be able to trust that firms are willing and able to implement the principles in a manner that accords with the spirit, and not just the letter, of the law.

Principles-based regulation puts more of a burden on firms' judgment and the ability of regulators to monitor firms effectively for compliance. On the other hand, rules-based regulation also requires some reliance on judgment and effective monitoring. In a rules-based regime, firms that do not act in good faith will seek loopholes to exploit and engage in regulatory arbitrage. Neither rules nor principles will effectively constrain firms' behavior in the absence of regulators with sufficient information and expertise to enforce them.

Principles versus rules literature applied to CCPs

The debate over the appropriate granularity of international guidance on CCPs is similar to the debate over whether principles or rules are most appropriate in a given regulatory context. The benefits of principles over rules are similar to the benefits of more general standards over granular guidance. Here, I argue that these benefits make a broad framework for international guidance the most effective and appropriate for CCPs.

Neither rules nor principles will effectively constrain firms' behavior in the absence of regulators with sufficient information and expertise to enforce them.

Like rules, granular standards can be useful where uniformity of regulation is desirable. However, where there are significant differences across regulatory jurisdictions—and in the business models and risk profiles of regulated entities—uniformity is unlikely to be desirable. The powers and capacities of CCP regulators vary across jurisdictions. Granular standards will inevitably be a better fit for one context rather than another, leading to inappropriate regulations for some of the affected entities.

It is also important to leave room for national variation because, across jurisdictions, CCPs vary widely in their business models and risk profiles. The most appropriate policies to ensure a given CCP is run well and prudently manages risk will vary with a CCP's location, ownership structure, and the products it clears. A state-run CCP may face different challenges than a shareholder-owned clearinghouse, and CCPs that clear options must manage different risks than CCPs that clear credit derivatives swaps. International guidance on CCPs needs to allow national regulators to take this variety into account.

Financial markets change quickly, and regulation must often adapt to those changes. General standards at the international level would allow national regulators to respond to market changes in an efficient and timely manner; unlike more granular guidance, the implementation of general standards can be adjusted as markets change without needing to amend the underlying text. A broad regulatory framework would also allow local regulators to take advantage of the expertise of CCP managers and users as they write rules appropriate for their specific context.

The failure of a major CCP would have significant negative effects on financial markets as well as the broader global economy. A box-checking mentality driven by granular international guidance that led to substantive, systemic concerns being neglected in favor of adherence to specific prescriptions could be especially problematic. The need for broader considerations in operating and regulating CCPs provides further support for a more general approach at the international level.

Overly prescriptive standards or regulations could also increase the likelihood that multiple CCPs fail at a given time, by encouraging many CCPs to act in similar ways and manage risk using the same tools and assumptions. As discussed earlier, a more general approach can reduce the risk that all CCPs behave in similar ways, increasing the resilience of the system overall.

Conclusion

CCPs play a crucial role in global financial markets. Their international importance has given rise to efforts to harmonize CCP regulation across jurisdictions. In this article, I argue that a regulatory framework promulgating general standards is most appropriate for international standard-setting bodies. I argue that a general approach best accords with the mandates of international standard setters and is the approach most likely to be effective. General standards can be used to establish best practices that all CCPs must meet, while leaving room for innovation and variation tailored to local circumstances.

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[1] Available online, https://www.world-exchanges.org/home/index.php/news/world-exchange-news/world-federation-of-exchanges-publishes-response-to-cpmi-iosco-consultative-report-on-ccp-resilience-recovery.

[2] Available online, http://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf, p. 2.

[3] Available online, http://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf.

[4] Available online, https://www.bis.org/cpmi/charter.pdf.

[5] Available online, https://www.bis.org/cpmi/charter.pdf, p.2.

[6] Standards for clearing agencies, available online, https://www.law.cornell.edu/cfr/text/17/240.17Ad-22; and 17 CFR 39.11—Financial resources, available online, https://www.law.cornell.edu/cfr/text/17/39.11.

Appendix: The development of international guidance on governance over time

Many efforts to establish international guidance for CCP regulation recognize the benefits of a general framework. These efforts establish clear expectations for CCPs, while allowing for differences in the operational and regulatory needs of CCPs that clear different products or operate in different locations. However, recent guidance, such as CPMI/IOSCO's "Resilience for central counterparties" (2017), appears to be increasingly granular, eliminating room for local regulator discretion and dictating specific ways that a CCP should be run.

If we look at one topic in particular, governance, we can see how international guidance began with broad principles and has increased in granularity over time.

A1. International guidance on governance of central counterparties

Document	Specific guidance
Recommendations for Central Counterparties (CPSS-IOSCO, 2004)	Governance arrangements should be clearly specified and publicly available. Objectives, those principally responsible for achieving them and the extent to which they have been met, should be disclosed to owners, participants, and public authorities.
Principles for Financial Market Infrastructures (CPSS-IOSCO, 2012)	An FMI should involve its participants and other stakeholders in the testing and review of its default procedures. An FMI should clearly and promptly inform its owners, participants, other users, and, where appropriate, the broader public, of the outcome of major decisions.
"Resilience of central counterparties (CCPs): Further guidance on the PFMI" (CPMI-IOSCO, 2017)	Sufficiently detailed, accurate, reliable, and timely information on the CCP's margin system and stress-testing framework should be provided to participants and other relevant stakeholders. The CCP should provide sufficient information to support the replicability of margin requirements. A CCP's board has the responsibility to ensure that the CCP's design, rules, overall strategy, and major decisions reflect appropriately the legitimate interests of its direct and indirect participants and other relevant stakeholders. Relevant stakeholders may include but are not limited to other CCPs, central securities depositories, securities settlement systems, and payment systems.

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