DTCC

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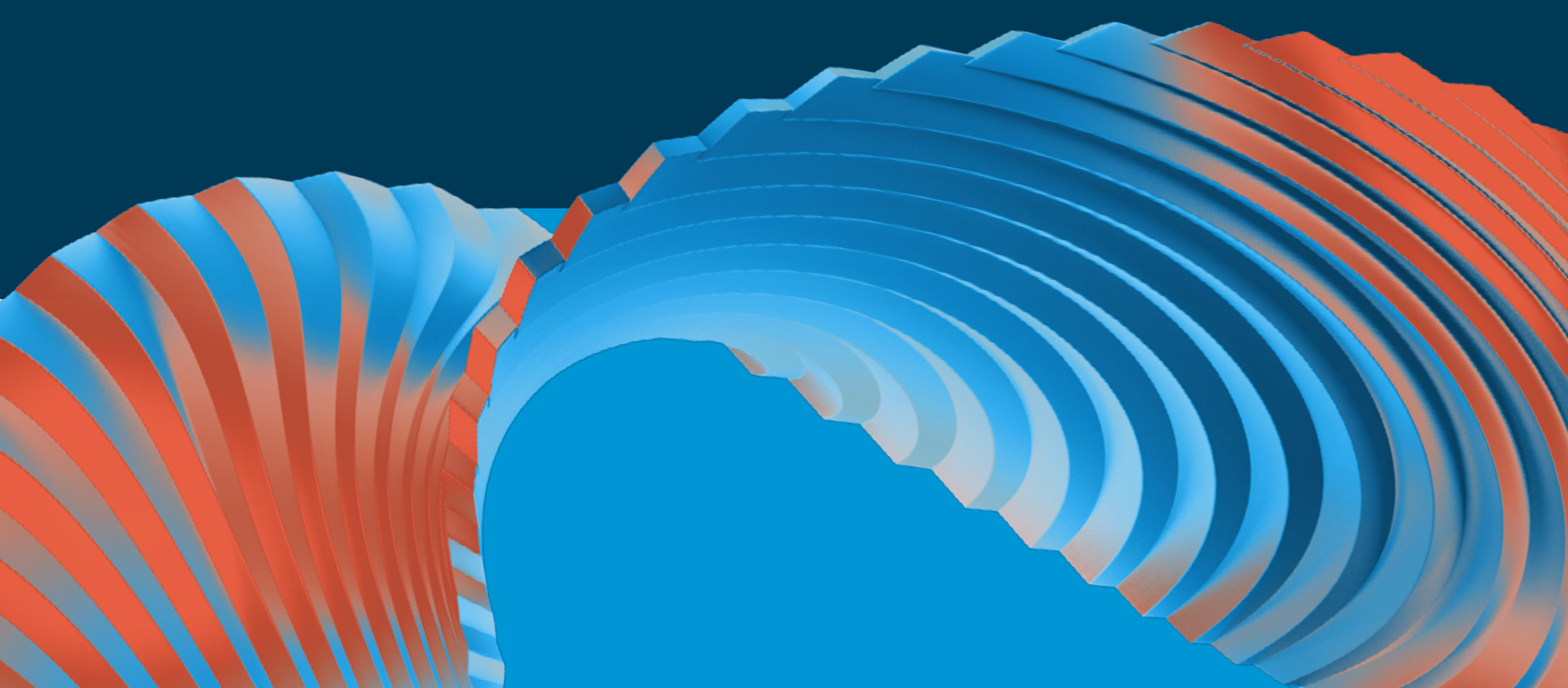
CCP PERSPECTIVES – MARKET RESILIENCE, STABILITY AND EFFICIENCY



CCP PERSPECTIVES – MARKET RESILIENCE, STABILITY AND EFFICIENCY

Built in partnership with the industry to provide stability and efficiency in the global capital markets, our U.S. cash market securities central counterparties (CCPs), National Securities Clearing Corporation (NSCC) and Fixed Income Clearing Corporation (FICC), provide critical clearing and settlement services for multiple asset classes, including U.S. equities, corporate and municipal bonds, as well as government and mortgage-backed securities. Together with The Depository Trust Company (DTC), which provides centralized securities depository, book-entry pledge/transfer, and net funds settlement for virtually all equity, fixed income, and Money Market Instruments in the U.S., FICC and NSCC stand at the center of global trading activity, processing trillions of dollars of securities transactions on a daily basis.

Recognizing that CCPs and Financial market utilities (FMUs) are a vital source of market stability, DTCC's primary function is, and has been since inception more than 40 years ago, risk management. This post, the first in a series introduces our work to reduce risks and promote resiliency, stability, and efficiency for financial market participants and the market as a whole.

RESILIENCY

Given a CCP's interconnected role, resilience is a foundational element of its risk management that focuses on the continued, end-to-end provision of critical business services. At DTCC, the approach incorporates resilience from the ground up into every stage of the development of new products and services. From an organizational point of view, this requires greater business ownership and accountability, as well as the development of a corporate culture and mindset that prioritizes resilience. Resilience is fundamental to our ability to serve the marketplace and protect the integrity and stability of the global financial system.

While the markets were experiencing extreme volatility during each of those periods, we were working behind the scenes with regulators and other market participants providing stability that is essential for the markets to continue functioning.

As the centralized clearinghouse for the U.S. capital markets, DTCC must clear and settle all transactions every day so the markets can open and trade the following morning. The COVID-19 pandemic market stress showed that DTCC processed trading activity based on our resiliency plans throughout the crisis while maintaining access to key business services for our clients. While the markets were experiencing extreme volatility during each of those periods, we were working behind the scenes with regulators and other market participants providing stability that is essential for the markets to continue functioning.

STABILITY

When an investor buys or sells shares in a stock, that transaction is routed to a CCP. After a trade is compared and verified, the CCP steps in between the two sides, and regardless of what happens to either party, it guarantees the trade will be completed. This provides certainty for investors and improves market safety by lowering exposure to settlement failure. A CCP's most important responsibility is guaranteeing trade completion in the event that one or both parties to that transaction defaults. This mitigation of counterparty credit risk is foundational; it is a CCP's primary responsibility.

A prime example of the critical role CCPs play for their members and the broader market is the Lehman Brothers bankruptcy and the resulting effort to close out Lehman's open positions. In the weeks that followed the Lehman bankruptcy, DTCC successfully closed out more than $500bn in market participants' exposure from the bank's collapse, the largest close-out DTCC has ever managed. The liquidation of Lehman was complex, involved multiple asset classes and required a methodical approach to mitigate potential losses from outstanding trading obligations. If you were a client of Lehman or traded with them at the time of their default, you didn't need to worry about receiving your securities or money because DTCC had guaranteed your trade.

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EFFICIENCY

Under the CCP netting system, all eligible compared and recorded transactions for a particular settlement date are netted by issue into one net long (buy), net short (sell) or flat position per client. For example, NSCC becomes the contra-party for settlement purposes, assuming the obligation of its clients that are receiving securities to receive and pay for those securities, and the obligation of its clients that are delivering securities to make the delivery. NSCC continuous net settlement system thus reduces the costs associated with securities transfers by reducing the number of securities movements required to settle transactions – generally by 98 percent.

WHY DTCC IS UNIQUE

DTCC is user-owned and governed by its members and was created to address concerns around settlement failures and restore confidence in the securities markets. DTCC's central role helps mutualize industry challenges, creating efficiencies and enabling participants to focus on differentiating services and capabilities to service their clients through, among other things, the netting of cleared trades for settlement and margin requirements.

IMPORTANCE OF TRANSPARENCY / DATA DISCLOSURE

By their nature, CCPs increase market transparency through, among other things, their maintenance of detailed transactional records, including counterparty identification and trade value, detailed rulebooks, which provide valuable information regarding a CCP's membership requirements and default procedures, and PFMI qualitative and quantitative disclosures. Nonetheless, given the critical role CCPs play in the financial markets, many market participants and policy makers have called for increased transparency around CCP practices to better understand potential exposures and anticipate possible increased margin requirements, cash calls, or unanticipated haircuts. In response, CCPs have sought to supplement the information they provide market participants.

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For example, DTCC's Risk Management as a Service (RMAS) initiative gives clients access to risk data, a new client portal to view intra-day and historical portfolio risks, and a client margin calculator. The transparency provided by the calculator gives clients the ability to submit intra-day or 'what-if' portfolios to gain an estimate of margin impact. Such a tool can be particularly valuable in times of market stress as it allows clients to better monitor and manage potential initial or intra-day margin (also known as variation margin) calls that could be made based on changing positions. Through this service, clients are able to monitor positions in real or near-real time.

In addition, NSCC recently enhanced its interactive Risk Client Portal and API to allow member firms to review 15-minute intra-day slices until 7:00 pm each day to monitor fluctuations in VaR and exposure to help anticipate potential intra-day margin calls and better forecast of next-day risk clearing fund requirements. NSCC released the detailed algorithm of its VaR formula within the portal to give clients the ability replicate the NSCC VaR formula in-house within their applications.

WHAT'S NEXT?

Concerns regarding the interconnectedness of market participants and participant uncertainties related to margin calls in times of stress have increased policy-maker focus, and work is underway to revisit standards and existing regulatory requirements. While this work is important, particularly given constantly changing market structures, it is important to note that the principle-based policymaking, such as the Principles for Financial Market Infrastructures, has to date allowed CCPs like FICC and NSCC to introduce additional transparency around recovery and wind-down, margin practices, and other matters for the benefit of their clients and market participants. Work has been, and will continue to be done, to provide information necessary to allow market participants to understand possible exposures and expected behaviors. Further some regulatory regimes, like that of the SEC's, enables markets participants to review and weigh in on any rule changes that an SEC-registered CCP may seek to make to its rule book, including with respect to its margin practices. Although additional work can and should be done to increase transparency regarding a CCP's practices, such as the transparency provided by DTCC's RMAS initiative, prescriptive requirements risk compromising a CCP's effectiveness in managing risk.

Recent debates about the sufficiency and appropriateness of margin calls in response to market volatility necessitates exploration of the considerations around stressed margin methodology, a task that DTCC is undertaking. In addition to assessing factors specific for DTCC's clearinghouses, in a coming article we will explore the unique features of our clearing activity, alignment of interests with our clients, supervisory guidance, and discuss how transparency and scenario analysis can assist our clients in managing their margin requirements with different levels of clearing activity.

CONCLUSION

CCPs, like other market participants, should continue to evolve to keep pace with changing market conditions and requirements. CCPs must, however, balance providing greater clarity in a manner that does not compromise the effectiveness of their risk management practices. Thus, CCPs should ensure transparency around their margin practices, membership standards, resolution plans, and modernization and resilience efforts, while maintaining sufficient discretion to quickly and effectively respond to dynamic market changes and extreme volatility events. In future posts, we will explore these topics and more. The vital role that CCPs play in the global financial market necessitates the dissemination of smart information.

We look forward to continuing an ongoing dialogue with our regulators, our peers and our clients about the vital role that CCPs and FMUs play in protecting the safety and security of the global financial marketplace.

As such, we encourage you to share your comments and feedback with us.

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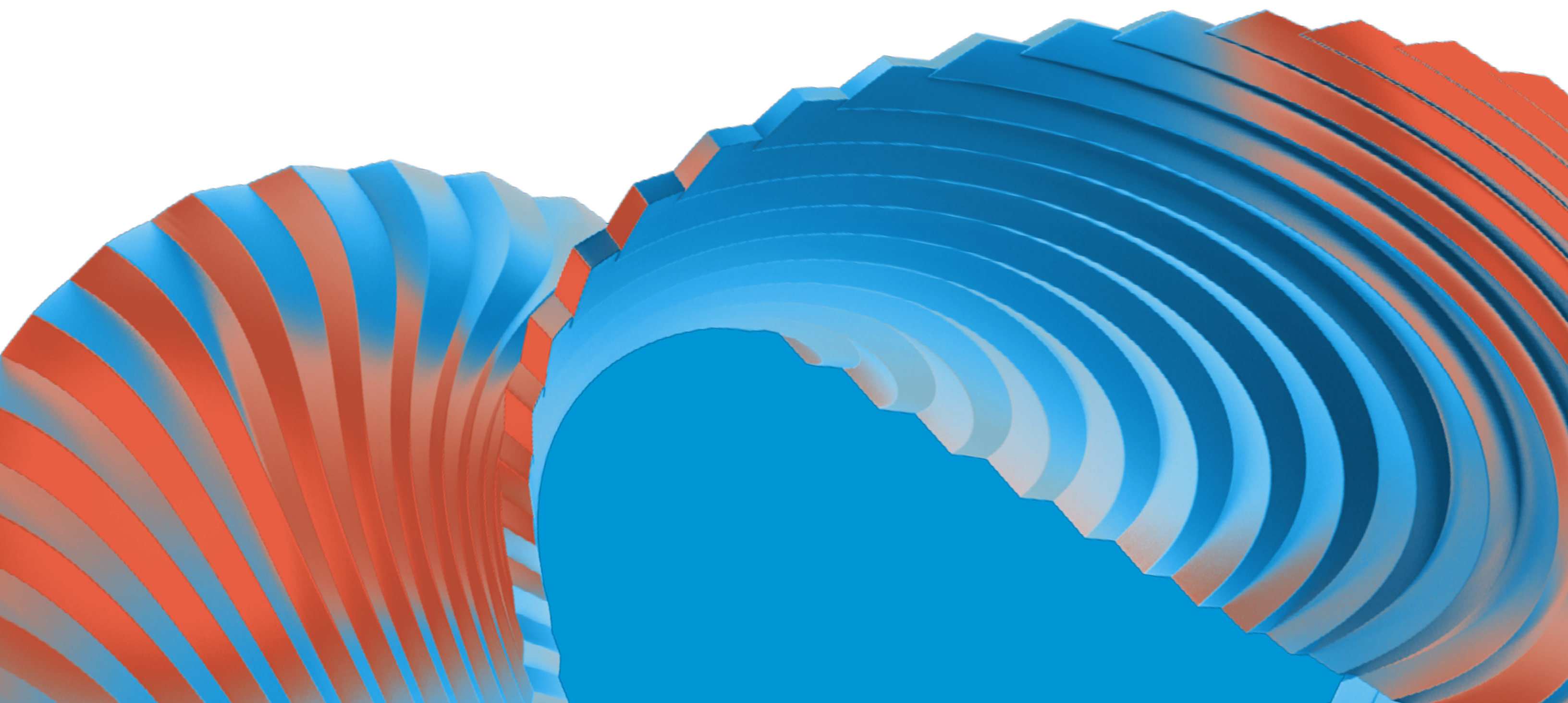

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