Living with the law of unintended consequences

One session at Sibos in Boston, entitled 'Market infrastructure crystal ball: what the future might bring and how to get ready for it', included contributions from, among others, Thomas Zeeb, CEO, SIX Securities Services. *Radar* asked Chris Hall, Editor, *Sibos Issues*, to reflect on whether financial market infrastructures are at the mercy of the unknown.

On the tablet of universal laws, somewhere between Newton's third law of physics ("for every action there is an equal and opposite reaction") and Murphy's law ("what can go wrong, will go wrong"), lies the law of unintended consequences. Researched and codified in the 1930s by US sociologist Robert Merton, the law reflects on the unpredictability of effecting change in complex systems, largely due to vested interests and human infallibility (best summarised as, "we can't agree on everything and we can't know everything").

Thomas Zeeb | SIX Securities Services

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Students of financial markets regulation will have noticed all three laws at work in the efforts of politicians, regulators and institutions to remake the industry in the aftermath of the global financial crisis. Attempting so many structural changes in so little time may be necessary, but it is not without risk. One of the central strands of the post-crisis reforms has been the migration of counterparty risk from banks to financial market infrastructures (FMIs), notably through the trading, clearing and reporting of OTC derivatives on centralised, openly accessible utilities. This represents a profound change in the role of FMIs, which have evolved gradually and sometimes idiosyncratically in national markets to mutualise risks and conduct common processes cost-effectively for members.

Though inevitable, the fact that this shift takes place in parallel with a forced overhaul of the business models and balance sheets of FMIs' primary users clearly invites the law of unintended consequences.

These issues were debated at Sibos in Boston, notably in 'Market infrastructure crystal ball: what the future might bring and how to get ready for it?', which included SIX Securities Services CEO Thomas Zeeb among its panellists. Speaking to SWIFT's Sibos Issues ahead of the session, Zeeb shared his fears over the "onerous" implications of mandatory clearing of OTC derivatives on central counterparties (CCPs). "I can perfectly understand the perspective of the regulators," he said. "The question,

Diego Valiante| European Capital Markets Institute

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To perform their existing roles and to compete for new business, CCPs have had to comply with CPMI-IOSCO 'Principles for Financial Market Infrastructures' as well as new legislation which has varied in detail and schedule across G-20 jurisdictions. In the European Union for example, CCPs have had to undergo a reauthorisation process to supply clearing services under the European Market Infrastructure Regulation (EMIR), entailing reappraisal of risk management, collateral management and default and funding arrangements, as well as the development of new account structures, against a backdrop of a constantly shifting deadline for the commencement of central clearing for different asset classes and counterparts. At present, clearing members must be ready to clear the most liquid interest rate

swaps from Q3 2015, with the subsequent timetable rolling out over the next three to four years.

At the same time, CCPs are being asked to put in place new recovery and resolution arrangements in keeping with the new role regulators have assigned to them. European legislation on CCP resolution is expected in 2015. Central banks are already working with CCPs to address systemic risk concerns. Addressing a conference in London in November, David Bailey, director, financial market infrastructure at the Bank of England said that, “CCPs must consider the recovery tools that they would employ if a non-default loss depletes the CCP’s capital. It is, however, important that recovery arrangements do not dis-incentivise effective management by CCPs of their non-default risks. CCPs should bear at least the first tranche of the loss with an amount of their own capital providing a clear incentive to prudently manage these risks.”

In effect, CCPs are being pushed through a series of regulatory hoops in preparation for a market demand that may not materialise as anticipated, potentially placing them at the mercy of all three of our laws. The situation is made more uncertain by the challenges facing clearing members. Basel III capital restrictions dictate that clearing members focus their balance sheet resources where they can expect the highest returns; i.e., on major clients, rather than extending their services to the mid-tier firms that have never before had to centrally clear. This economic disincentive to offering indirect clearing services could effectively bar potential customers from central clearing, limiting future CCP volumes and revenues.

For European central securities depositories (CSDs), there are similar but not identical challenges ahead. Both the introduction of TARGET2-Securities – the European Central Bank’s harmonised securities settlement platform – and EMIR’s incoming requirement for CCPs to hold collateral in securities settlement systems encourage CSDs to develop new services. “There is a huge opportunity for expansion by CSDs,” says Diego Valiante, head of capital markets research at the European Capital Markets Institute. “But to grasp it they must become more international in scope and they must move up the value chain, for example into corporate actions and collateral-related services such as segregated accounts.”

But at the same time the regulatory burden is intensifying. Blogging in Boston, SIX’s Zeeb noted the tension between business development and systemic integrity and stability: “FMIs have a key part to play in maintaining the integrity of the financial system through the flow of high-quality collateral. If you ask any CSD, each one would agree that CSDs shouldn’t compete on quality of collateral. Regulators have a role to play here by guiding FMIs on issues.”

European CSDs are already undergoing a period of process harmonisation, including migration to T+2, under the European Commission’s Central Securities Depositories Regulation and face the same resolution and recovery demands as CCPs, while being expected to help address the industry-wide challenge of mobilising collateral to support OTC derivatives clearing and the capital and liquidity requirements of Basel III. “It is inevitable that the new rules aimed at reducing systemic risk – such as the increased collateralisation of transactions and requirements for account segregation – will reduce the velocity of collateral. FMIs are already doing a lot to reduce the impact of this slowdown – for example real-time risk management is now a reality - but they still face many sources of uncertainty resulting from the regulatory reform process,” says Valiente.

Among all this reform, it might seem unwise to suggest yet another law, but perhaps there is a need for one more law to bind them: “When proposing two or more new regulations, do not proceed without first considering their interdependencies.” •