# GCSA Capital: the CCP underwriter

**A consortium of 20 insurers is offering to cover CCP tail risk, and its chairman, David Hardy, believes the cost of clearing could be reduced as a result. By Tom Osborn**

Insurance salesmen run into a lot of scepticism. Whether they're selling a few grand of cover for a used car or billions of dollars of insurance for catastrophic losses at a clearing house, the gripes are often surprisingly similar, says David Hardy, chairman of insurance consortium GCSA Capital and former chief executive of LCH.Clearnet.

"The first thing everybody says to us is, 'Oh, insurance never pays up, and even if it does, it won't be on time.' We hear that. That's why we've worked with industry stakeholders in designing the structure we've come up with to try and solve those concerns," Hardy says.

GCSA has partnered with broker Lockton to form a consortium of 20 insurers, many of them Lloyds of London members, with collective claims-paying ability north of $300 billion – offering policies to central counterparties (CCPs) that will underwrite losses incurred from member defaults, replenish a depleted default fund, or insure against non-default losses.

To date, only one CCP – Norway's NOS Clearing – has taken out an early iteration of one of GCSA's policies. But the current zeal among international regulators, as well as dealers and large asset managers, for CCPs to firm up their recovery and resolution plans has presented the consortium with a huge opportunity, Hardy believes (*Risk* November 2014, *www.risk.net/2376693*).

"The key thing we had to get right was the claims mechanism. If you do that, then it doesn't matter whether the insurer pays up immediately; with an irrevocable commitment to pay, the CCP can take other measures to ensure immediate liquidity should it need to. CCPs won't be handed a 25-page claim for a policy that takes three months to decide whether to pay out or not. The decision is immediate," Hardy says.

In effect, GCSA will engage in pre-claims management with policy-holding CCPs on an ongoing basis, says Hardy, running fire drills and conducting monthly reviews that evaluate whether a CCP is abiding by agreed terms. The consortium may end up stressing CCP margin calculations and related metrics more strenuously than the CCPs themselves, says Hardy, in order to satisfy its insurers that the methodologies a CCP has in place are robust and working as designed.

"If a CCP was demonstrably failing to follow its procedures, that would certainly complicate our relationship. For example, if it had cut its margins to a point where, actually, it was only intending to cover risk to a confidence level of 80% rather than 99.5%, then we would take issue. But so would the clearing member base. In effect, we're insuring the margin mechanism. Our consortium wants to know what would have to happen for the methodology to break down, so we monitor everything from margin performance to rule book changes. That's how we can provide an additional form of macro-prudential surveillance."

Biography – David Hardy
2013–present – chairman, GCSA Capital
1985–2006 – initially seconded to LCH.Clearnet. Appointed full-time chief executive in 1987
1973–1985 – various roles at Barclays

The structure of each policy is unique to the holder, and private. But it is understood GCSA prices the offering according to its assessment of the adequacy of a CCP's resources, its default management procedures, and the relative creditworthiness of its members, even applying its own system of credit ratings. And, as with any insurance policy, prices are partly a matter of negotiation, Hardy says. He acknowledges arguments from some quarters that CCPs might choose to pass the cost of the policy onto their clients, which might then build it into their clearing fees, but he argues that shouldn't lead to a material rise in the cost of clearing.

If anything, the reverse could end up being the case. Collectively, CCP default funds around the globe currently tie up around $35 billion in dealers' capital, which gets factored into the cost of clearing, to a greater or lesser extent. Were CCPs to begin adopting insurance wholesale, that could change, Hardy believes.

The idea of underwriting CCPs is not a new one. As head of what was then the London Clearing House in 1988, Hardy took out a policy from Trade Indemnity, a trade credit organisation. "At the time, the six banks that owned LCH's parent company were getting a bit jumpy about the moral hazard of ownership. In the event of a default, the company had £15 million of share capital – and that was it. By that stage, it was clearing Liffe, the International Petroleum Exchange and the London Metal Exchange."

The experience wasn't a terribly good one though, he adds. "After a few years, the underwriter worked out it wasn't making very much money from us, but that it was covering quite a large risk – so the cover wasn't renewed. At the time, it was a nuisance, but ultimately it was a good thing, because it started the discussions that led to the reorganisation of LCH in the mid-1990s, and ultimately the birth of services like SwapClear and RepoClear in 1999."

**Tom Osborn**

Photos: Juno Snowdon