The Systemic Risk Council

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U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

U.S. House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

SUBMITTED VIA EMAIL

March 3, 2021

RE: US EQUITY TRADING SQUEEZES, AND VOLATILITY: AMBER ALERT OF FINANCIAL SYSTEM FRAGILITIES

Dear Chairman Brown, Chairwoman Waters, and Ranking Members Toomey and McHenry,

US equity markets were recently roiled by extraordinary volatility in a small number of stocks. This was driven by leveraged retail investors crowd-buying stocks that had been short-sold by levered funds of various kinds. The music stopped when the US-equity clearing house called for extra collateral from some of its members, who promptly closed out their clients' positions or cut off their execution services.

This ugly episode raises all sorts of questions about the integrity and efficiency of one of the world's most important capital markets. But the focus of the Systemic Risk Council is solely on those related to the resilience and stability of the financial system. In this short letter, we propose that the Senate and House committees ensure that the following four financial stability-related questions are properly addressed by the relevant regulatory agencies:

- Whether the clearing house's collateral practices were sufficiently disciplined
- Whether capital requirements for broker dealers are high enough
- Whether re-hypothecation of collateral should be banned, or constrained
- Whether the financial authorities could have done more to maintain

system-wide resilience as feverish levered trading in capital markets was fueled by sustained monetary measures to support economic recovery

Background

On January 28, 2021, the National Securities Clearing Corporation (NSCC), the US-equity-settlement clearing house, called for more collateral from a zero-commission discount brokerage called Robinhood. As well as raising new capital (debt convertible into equity) to help it meet the margin call, Robinhood stopped taking orders from retail customers to purchase the equity of GameStop, a smallish chain of video-game rental stores which, according to media reports, had already been struggling before the pandemic. These various actions, possibly matched at some other brokers, followed an extraordinarily strong rise in GameStop's stock price, apparently driven by crowd-buying prompted by public discussions on a social media site (Reddit).[1]

Those purchases were large relative to normal trading in the stock, and a high number of trades had failed to settle on time.[2] It seems many purchases were not pre-funded, meaning investors were in effect leveraged for the period of two days until settlement (and perhaps longer in some cases). Meanwhile, a variety of trading funds had short-sold the stock, partly because the firm's business had been adversely affected by the pandemic, as well as, possibly, by ongoing structural change in its market. Some of those short positions seem to have been leveraged, so a partly leveraged purchasing community was pitted against leveraged sellers. As the stock's price rocketed, prime brokers to the short-sellers will have required more collateral, adding to the squeeze to the extent that traders with short positions hedged or closed out. With the stock's price and the associated leverage rising, someone --- the clearing house, as its own exposures accelerated --- effectively called stop on the GameStop spectacle.

The four issues which the Systemic Risk Council (SRC) recommends should be followed up to protect financial stability are as follows.

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[1] Reddit appears to be facilitating the dissemination and promotion of ideas to buy or sell securities, and derivatives on securities, which is more a matter concerning the fairness and efficiency of US financial intermediation rather than, directly, systemic resilience and stability in the provision of financial services.

[2] As published in the SEC's report on "Fails-to-Deliver." SRC understands that this does not reveal which leg of a transaction (purchase or sale) failed to deliver on schedule.

Collateral requirements, and the systemic role of clearing houses

Clearing houses stand between the trades of their members. Because the clearing house is exposed to the risk of default by its members, it requires them to put up collateral; this provides protection against loss when the clearing house closes out the positions of a defaulting member. Clearing houses require their members to top up collateral each day as needed, as prices fall and rise. They may also increase their initial collateral requirements if markets become more volatile or vulnerable, thereby maintaining their desired protection against member-default risk.

Like collateral requirements in any bilateral transactions, clearing house requirements should be calibrated taking into account the circumstances that would likely prevail if particular members defaulted. Collateral matters only when the financial weather is bad, and a professional clearing house should consider whether defaults by a particular member or in particular market conditions would bring on, and exacerbate, bad weather.

Since the recent market squeeze came to an abrupt halt when the clearing house called for more collateral, it is legitimate to ask (a) whether its requirements were too low to begin with: were they calibrated for sunny rather than inclement weather; (b) whether the clearing house was too slow to call for additional collateral; and (c) whether their internal protocols and processes, and those of their regulatory overseers, were fit to cope effectively with the situation they faced.

This matters for two reasons. First, because clearing houses become the legal counterparty to the transactions they clear or settle, their standards and policies affect both their own risk exposures and those of the system more widely. They are, in effect, system-risk managers. In the light of the latest episode, it is important to ask whether they were properly managing the risks in the part of the system they preside over. If not, the authorities --- and, more important, the public --- have a big problem.

Second, any deficiencies in clearing houses' management of their own risks increases the probability --- in different circumstances involving larger amounts than recently --- of one of them getting into trouble themselves. That would be an absolute disaster as clearing houses are super-systemic, especially given the authorities still do not have credible plans for how to resolve a failed clearing house without taxpayers' money (if in-life recovery measures did not suffice).[3]

The collateral policies of the clearing house, and of cash-market brokers, are plainly related to the settlement period; broadly speaking, the longer the settlement period, the greater the period in which volatility can take a stock's price at the settlement date away from the purchase/sale price. This has prompted calls for reductions in the US-equity settlement period from its current two days (T+2).[4] The pros and cons of this are worth considering, taking into account available remedies for the problem of trades not settling on time. But whatever the settlement period, collateral requirements and practices need to be adequate.

Capital requirements for US broker dealers

The broker dealer in the case, Robinhood, suddenly needed to raise a lot of capital. The obvious question is why it was intermediating more business than its capital base could support (a form of overtrading). Stock brokers' capital is subject to regulation precisely because private brokers and dealers do not have incentives to weigh the wider costs of their failing, so it should not come as a surprise when a broker dealer overtrades if it is left to its own devices: that is the history of our capital markets.

The question, then, is whether SEC equity requirements are properly calibrated against the kind of volatility and the degrees of leverage that seem to characterize modern markets. Since that proved a problem on a spectacular scale in 2007/08, legislators and regulators should lift every stone to see whether it remains a problem.

That examination should include looking at how much of the open-interest in the squeezed securities and instruments was financed by particular discount brokers, prime brokers, and banks. Concentrated books among prime brokers and others can fuel herding behavior when fast markets turn, and obviously expose the financiers themselves if the loans are large relative to their capital

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[3] *See* Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (July 31, 2020), available at http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2020/07/Comment-Letter-of-Systemic-Risk-Council-on-FSB-Consultation-on-CCP-Resolution-Guidance7.31.2020.pdf.
[4] Statement by the Depository Trade Clearing Corporation: https://perspectives.dtcc.com/articles/leading-the-industry-to-accelerated-settlement

and liquid resources.

The re-hypothecation of collateral

Some of the retail investors who crowd-bought the stocks seem to have financed their purchases by pledging —- or, as it is sometimes known, hypothecating — the equity to their brokers as collateral. Brokers, in turn, seem partly to have financed themselves by on-pledging —- re-hypothecating — the securities to bigger dealers and banks. And so on until the clearing house is reached. These are known as re-hypothecation chains. Often, the degree of leverage (resources lent relative to excess collateral) increases with each link in the chain, creating system vulnerabilities that are greater than revealed by the leverage at any one link in the chain.

After the 2008/09 financial crisis, there was a public debate about whether legislators or regulators should bar re-hypothecation. That would mean that if a broker lent money against a customer's stock, the broker would have to finance itself from its own resources rather than by borrowing against its customer's property.

The SRC does not have a position on whether or not hypothecation should be barred. The issue needs re-litigating, including ensuring that re-hypothecation is not occurring where, given particular customer or regulatory constraints, it is not meant to.

Separately, the SRC suggests that chains of re-hypothecation --- too often a fancy way of describing chains of accumulating leverage --- warrant higher rather than lower collateral requirements.

Complacency about easy monetary policy's effects on financial market exuberance

For over a decade, economic recovery has relied upon extraordinarily easy monetary conditions. While many would have preferred fiscal policy to have borne more of the burden, the financial authorities are responsible for addressing the world as it is, not as it might have been. That should have included exploring what they could do to constrain, even choke off, excessive leverage in a range of capital markets. They might have tried to do this by exercising powers, some dating back to the 1930s, to raise minimum collateral haircuts in certain capital markets, so as to cap the leverage that was available to traders and others.

This seems not to have been considered. It would be sensible and useful for legislators to ask why not. The West cannot afford another financial crisis, and yet, if only by default, leveraged exuberance seems to have gained hold again.

Summary

The recent equity market kerfuffle was not a direct threat to the stability of the financial system, and so did not jeopardize the provision of financial services to US households and businesses. But one of the most powerful lessons of the past quarter century is that the authorities must energetically learn from near misses and ugly episodes. The scramble to increase collateral requirements, close-out positions, and cut off services offers quite a lot for securities and banking regulators to chew over. The SRC urges the Congressional oversight committees to ensure that they do, and that the unfinished business of rebuilding the financial system's resilience resumes.[5]

Yours sincerely,

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
www.systemicriskcouncil.org

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[5] *See* The Systemic Risk Council, Statement to the Finance Ministers and Central Bank Governors of the G20, the Financial Stability Board, and International Standard-Setters (Oct. 9, 2020), available at http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2020/10/SRC-Reigniting-the-Reform-Debate.pdf.

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