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Protecting Futures Customers from Brokerage Firm Failures, Part 2

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An earlier article (*farmdoc daily* January 15, 2014) described a National Futures Association study published in 1986 which explored the feasibility of a protection fund for futures customers. The purpose of such a fund would be to quickly restore missing customer funds in the event of brokerage firm failure (such as MF Global) or fraud (such as Peregrine Financial Group). The study found shortcomings with funding this program using either commercial insurance and or an accumulated cash fund modelled after the Security Investors Protection Corporation (SIPC).

A new study by Compass Lexecon, a leading economic consulting firm, was released in November 2013. This study was funded by CME Group, the Futures Industry Association, the Institute for Financial Markets, and the National Futures Association. It focused on the use of insurance - either a private, voluntary program or a government-mandated, universal program - as the basis for a futures customer protection fund.

Basic Features of Insurance

The deductible - the dollar amount of each claim that is not covered by insurance and remains the responsibility of the policyholder - is an important feature of any insurance policy. Requiring a policyholder to pay the first X percent or the first X dollars of each loss encourages the policyholder to manage his or her risks responsibly. Without a deductible or other means to cause the policyholder to keep some "skin in the game," the policyholder might be tempted to behave irresponsibly because his/her losses would be fully covered by insurance. For example, a customer might decide to not meet a margin call - like in the Volume Investors case - and cause the firm to collapse. This situation is known as known as "moral hazard" and is one of the reasons why higher deductibles result in lower premiums, all other things being the same.

If customer funds held at brokerage firms were insured, most customers would find it unfair to recover anything less than 100% of their missing funds. Thus, for commercial insurance to be a feasible solution, brokerage firms would need to reimburse customers for the deductible on any claims. But reimbursing

customers becomes problematic both because of the amount of money involved, and because of the way in which most losses of customer funds occur.

Suppose that MF Global's US customers had been covered by an insurance policy. Using bankruptcy claims data, there were 27,000 customer claims for a total of $6.4 billion (most of which has since been recovered), for an average of $237,000 per customer. If this policy had a $1,000 deductible per customer - so that insurance would cover everything except the first $1,000 of each customer's claim - total customer deductibles would have been $27 million, or 27,000 customers x $1,000 per customer. Therefore MF Global would have been expected to keep $27 million in reserve to reimburse customers in case it folded. But as everyone has learned, MF Global didn't honor its existing obligations to safeguard customer funds, so there is no reason to believe it would have funded (or would not have tapped) this reimbursement fund as its financial condition deteriorated.

Broker-Funded Reserve Fund

Setting aside a reserve fund for customer deductibles would pose a financial burden for any brokerage firm. Simply put, brokerage firms don't have several million dollars of extra cash lying around. Futures brokerage is highly competitive and profit margins are extremely thin, so the costs of providing a deductible reimbursement fund would almost certainly lead to higher brokerage fees for customers.

Some observers have suggested that firms might find it attractive to offer insurance to its customers on a voluntary, firm-wide or customer-by-customer basis. Under this scenario, establishing a reserve fund would demonstrate to customers that their funds are safe, and as a result customers would migrate to such firms. However, such a large financial commitment, for which the costs would be passed along to customers, instead could put the firm at a competitive disadvantage because customers historically have shown little appetite for higher trading fees, regardless of the benefits.

Coverage Levels and Premiums

While the customer deductible issue represents a major hurdle in developing a workable insurance solution, it is not the only barrier. Other issues are the amount of coverage and the cost of the premiums. To this point we have assumed that coverage - the maximum amount paid per customer or per event - would be unlimited. In practice, coverage is almost always "capped" at some level, because insuring a potentially unlimited risk could require potentially unlimited premiums, and because unlimited coverage can lead to moral hazard.

The study explored in detail the creation of an insurance company by several brokerage firms. This so-called Futures Industry Customer Asset Protection Insurance Company (FICAP) would insure the customers of the participating firms. The brokerage firms belonging to the group would absorb the first $50 million per year in customer claims for any participating firm in the group that failed. Then FICAP would cover losses up to $50 million per firm and up to $250 million for the group. A proposal submitted by a consortium of eight reinsurers estimated the premiums for this coverage at 6% to 9% per year of customer funds held at each firm. While the study assumes that customers would pay these premiums, it is not clear that they would do it willingly, or in the numbers necessary for a viable program.

Mandatory Protection: "SIPC for Futures"

All of the foregoing plans were voluntary, but the study also examined a government-mandated protection plan that would apply to all customers at all firms. Like SIPC, it would provide up to $250,000 per customer and would involve no deductible, so customers would be fully covered beginning with the first dollar of loss from a brokerage firm failure. Funding would come from charging brokerage firms 0.5% of annual gross revenues related to futures trading, until the fund reached its target level of $2.5 billion. These figures are comparable to those used by SIPC for securities customers.

The futures brokerage industry is substantially smaller than the securities brokerage industry, so the "tax base" for accumulating funds is correspondingly smaller. The futures industry had only 110 brokerage firms registered with the CFTC at the end of 2012, compared to the 4,364 firms in the securities industry that participated in SIPC. Similarly, the industry revenues used to calculate assessments for the customer protection fund are much smaller: $5.1 billion for the futures industry compared to $164.8 billion for the securities industry. As a result of these differences, the balance in the futures fund would accumulate very

slowly. If no futures claims were filed and accumulated funds grew at a 2% compounded rate, it would take 54 years to reach the $2.5 billion targeted level. Despite the attractiveness of a "SIPC for futures" fund, the futures industry simply is not large enough to support such a program.

References

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