Allen & Overy LLP

MEMORANDUM

To ISDA

From Damian Carolan, Knox McIlwain, Jack Prettejohn

Our ref DAMC/KNOM/0030047-0001097 UKO1: 1007927534.10

Date 02 April 2020

Subject Proposed CCP Recovery & Resolution Regulation: NCWO principle and CCP equity

1. INTRODUCTION

1.1 This memorandum considers the type and nature of loss to which the equity of EEA central counterparties (CCPs) might be exposed on a CCP resolution based upon the proposed CCP recovery and resolution regulation1 under the Council compromise text2 (the Draft Regulation).3 In particular, we consider whether CCP equity would naturally be expected to be written down whenever a resolution occurs.

1.2 We have focussed on resolution caused by clearing member default losses. We note that non-default losses are not generally capable of broad-ranging redistribution to clearing members through CCP loss allocation rules so the issues reviewed in this memorandum are less relevant in scenarios of CCP resolution caused by non-default losses (i.e. where a CCP suffers significant non-default losses, it is more obvious that CCP equity is exposed to a risk of loss and a ‘no creditor worse off’ (NCWO) insolvency counterfactual which assumes full usage of CCP rulebook powers would not contradict that).

1.3 We express no view as to the “right” level of losses which should be borne by CCP equity as opposed to other stakeholders. This memorandum only sets out the likely practical effect of certain provisions of the Draft Regulation as currently drafted when considered in the context of the manner in which CCP rulebooks are generally structured today. It is for policymakers to decide what their intent is


3 Although we consider the text prepared by the Council (as the latest available version), the position described below is materially the same in the initial proposal prepared by the Commission (adopted on 28 November 2016, available above) and compromise text prepared by the European Parliament (adopted on 27 March 2019), albeit that the location and/or precise wording of the provisions may differ slightly.

regarding such losses, and any possible consequential compensation for affected parties. It is acknowledged that the Commission’s intentions may be subject to further development.¹

1.4 Unless otherwise stated, references to Articles and Recitals are references to the Articles and Recitals of the Draft Regulation.

2. EXECUTIVE SUMMARY

2.1 The Draft Regulation establishes a wide-reaching regime directing how CCPs may be subject to resolution by their resolution authorities. The Draft Regulation makes clear that clearing members of CCPs are not intended to bear the financial burden of restoring the CCP to viability on their own: in drafting this regime, the Commission has established its intention that CCP equity should “bear first losses” in the CCP’s resolution.

2.2 However, the intention for CCP equity to bear first losses is caveated such that this occurs “following the enforcement of all contractual obligations and other arrangements in the CCP’s recovery plan”. Part of the intention behind this proviso is to avoid litigation by CCP shareholders against resolution authorities. This could arise where the actions taken by resolution authorities result in different outcomes for CCP equity than would have arisen in the absence of resolution action – i.e. in insolvency. It is in part due to this that the NCWO provision is included.

2.3 In line with the approach set out above, the NCWO provision is applied “following the full application of the applicable contractual obligations and other arrangements in its [the CCP’s] operating rules”. Therefore, whilst CCP equity is exposed to “first losses” in resolution, whether there will in fact be any “first losses” at all in a CCP resolution depends on the “contractual obligations and other arrangements” of the CCP under its CCP rules and CCP recovery plans.

2.4 EMIR⁵ requires an element of a CCP’s own resources (i.e. the CCP’s so-called ‘skin in the game’ (SITG)) to be used “before using the default fund contributions of non-defaulting clearing members.” Beyond this, there is no harmonisation of CCP default fund waterfalls and the risk management and loss allocation tools granted to CCPs in their rulebooks, even though all seek to discharge the same obligations.

2.5 It should not be assumed that the residual equity of the CCP is included at the end of the default waterfall. The benefits of segregated cleared services and related default funds within a single CCP are widely recognised and have been implemented in some CCPs. In order to make segregated services / default funds work effectively, it is necessary that the end of the waterfall for a particular service does not include residual CCP equity – to do so would have the effect of reintroducing contagion risk between services.

2.6 It also should not be assumed that there will be any losses left to be absorbed by CCP equity, in a default loss scenario, after the full application of CCP rules and recovery plans. Requirements on CCP’s rules and recovery plans state that a CCP must have comprehensive powers to restore the CCP to financial viability. EMIR requires CCPs to have appropriate risk management tools to enable it to “manage ... all relevant risks”. The Draft Regulation requires CCP’s recovery plans to be capable of fully managing financial risks by using powers such as variation margin gain haircuts, other loss allocation and position allocation. The contractual limits placed upon these tools vary among CCPs and, even where CCP equity is included at the end of the default waterfall, this can still be subject to limited recourse provisions that place restrictions on absorption of losses by CCP equity.

---

¹ The Draft Regulation refers, at Recital (81a), to the possibility that it may be reviewed by the Commission following further developments in the approach adopted by guidance expected to be published by the Financial Stability Board (FSB) at the end of 2020.

2.7 We consider that all of the measures described above that reside in CCP rulebooks would be considered part of the “applicable contractual obligations and other arrangements in its [the CCP’s] operating rules”. These measures are therefore all relevant to the NCWO counterfactual assessment that would apply to equity and clearing member positions when considering the mandated scope of “first losses” and the loss allocation by the resolution authority pursuant to the NCWO principle.6

2.8 Based on the current drafting of the Draft Regulation, CCP equity’s exposure to “first losses” and the NCWO principle both occur after the hypothetical full application of the CCP’s rules and recovery plan – i.e. the position is assessed after the assumed use to the fullest extent possible of the tools noted above to reinstate a matched book, restore the CCP’s financial resources, and allocate to clearing members any CCP losses arising from this process.

2.9 Since CCP rulebooks are often designed so that insolvency may in practice be avoided in all cases by continued use of available rulebook tools, this suggests there may well be no “first losses” to allocate to CCP equity. This will of course always be a fact-specific and CCP rulebook-specific assessment but, unless these tools are restricted in their application prior to resolution, beyond the CCP’s mandatory use of its SITG, then equity might well not be at risk in a hypothetical CCP insolvency.

2.10 The approach to NCWO might also leave open the possibility that equity holders would have a NCWO claim of their own in the event that they were asked to absorb losses which could in fact have been otherwise addressed or allocated by full use of contractual powers available in the CCP rules outside of resolution.

3. LEGISLATIVE SOURCES: BASIS FOR CCP EQUITY TO BEAR LOSSES IN RESOLUTION

3.1 The principle that it should be possible for CCP equity to bear losses in resolution, and that they should do so first (i.e. ahead of clearing members and other creditors), is clearly established in the Draft Regulation:

(a) Recital (33) states that: “Equity holders of a CCP should absorb losses first in resolution in a way that minimises the risk of legal challenge by them where such losses are greater than the losses that they would have incurred under normal insolvency proceedings (the no-creditor-worse-off principle).” [emphasis added].

This point is reiterated in Recital (81a) and Article 21(3)(b).

(b) The same principle is supported by the NCWO provision itself in Article 60, which refers to the need to ensure that, “shareholders, clearing members and other creditors, do not incur greater losses than they would have incurred had the resolution authority not taken resolution action” [emphasis added].

Reference to “greater” clearly denotes that CCP equity (among others) should bear losses in resolution. This point is reiterated in Article 62.

3.2 Further supporting the principles noted above, it is clear that it is not the intention for clearing members to bear all the financial burden of restoring the CCP to viability, as Article 27(6) enables the financial burden on clearing members to be adjusted in line with the NCWO principle:

“Where the use of a resolution tool other than the write-down and conversion tool results in financial losses being borne by clearing members, the resolution authority shall exercise the power to write down and convert any instruments of ownership and debt instruments or other

6 There is one exception to this in the Draft Regulation, which is the new concept of a resolution cash call – a further cash call on clearing members only available in resolution –this is described in the Draft Regulation as not to be taken into account when assessing NCWO.
unsecured liabilities in a sequence that minimises deviations from Article 60 [the NCWO principle].”

4. APPLICATION OF THE NO CREDITOR WORSE OFF (NCWO) PRINCIPLE

4.1 The principle of a no-creditor-worse-off safeguard is of course well understood in a bank recovery and resolution context. It, however, is equally understood that the insolvency counterfactual which is meaningful for banks does not easily translate to CCPs, which achieve much of their financial robustness through mutualised loss-sharing rather than own capital and also, as noted above, have rulebook powers that allow them to reduce/remove the realistic risk of insolvency in a way that is not possible for banks.

4.2 The drafting of the NCWO in Articles 60, as well as the supporting principles set out in Article 23(1) and Recitals (33) and (81a), caveat the allocation of “first losses” to CCP equity such that this should only occur “following the full application of the applicable contractual obligations and other arrangements in its [the CCP’s] operating rules” (Article 60).

4.3 We consider below the meaning and scope of these “contractual obligations and other arrangements”. It is useful in this context to note the rationale for this provision that is set out in Recital (81a): “equity holders of a CCP absorb losses first in resolution in a way that minimises the risk of legal challenge by equity holders, on the basis that their losses in resolution are greater than the losses that they would have incurred under normal insolvency proceedings (the no-creditor-worse-off principle).” [emphasis added].

5. CCP RULES & RECOVERY PLANS

5.1 It is our understanding that the relevant “contractual obligations and other arrangements” are CCP’s rules and their recovery plans. These are contractual arrangements to which clearing members are bound, giving the CCP powers to handle default loss scenarios (among other situations).

Requirements to expose CCP equity to loss in the default waterfall

5.2 EMIR and the Draft Regulation contain provisions that aim to expose CCP an element of equity to losses in the application of the CCP’s rules and recovery plan.

5.3 Firstly, in a default scenario, Article 45(4) EMIR provides that: “A CCP shall use dedicated own resources [i.e. its SITG] before using the default fund contributions of non-defaulting clearing members.” The level of SITG held varies among different CCPs.

5.4 Secondly, Article 9a (which is echoed by Recital (22)) provides that: “The CCP shall use its own resources, held by the CCP to comply with Article 16 of Regulation (EU) No 648/2012 [i.e. its regulatory capital], as a recovery measure before resorting to other recovery measures requiring financial contributions from clearing members.”

Requirements for loss allocation powers

5.5 The requirements applicable to CCP rulebooks and recovery plans mean that there may not be any losses left, following the assumed full application of these powers, to be absorbed by CCP equity (other than SITG, as noted above).

5.6 CCPs are obliged to have comprehensive rulebooks that grant the CCP powers to fully manage their risk exposure. Article 26(1) EMIR obliges a CCP to have “effective processes to identify, manage,
monitor and report the risks to which it is or might be exposed” [emphasis added]. This requires CCPs cover “all relevant risks” to which they could be exposed.7

5.7 Further, CCPs are obliged to draft their recovery plans in such a manner that the CCP does not incur losses. Article 9(1) provides that CCPs must protect themselves against uncovered liquidity shortfalls, default losses (i.e. re-establishing a matched book), and non-default losses.

5.8 Annex Section A(2)(4) expressly requires CCP recovery plans to contain “a comprehensive range of capital, loss allocation, position allocation and liquidity actions required to maintain or restore the viability and financial soundness of the CCP including to restore its matched book and capital, and replenish pre-funded resources” [emphasis added]. This allows for the possibility for loss allocation actions to include “cash calls and a reduction in the value of gains payable by the CCP to non-defaulting clearing members, where defined in the operating rules of the CCP”.

5.9 As a result, the core powers contained in CCP rules and recovery plans are required by regulation to be pre-configured to rely on resources provided by clearing members and a set amount of SITG rather than using CCP equity.

6. ACTIONS IN RESOLUTION

6.1 The issues considered above in relation to the rules and recovery plan of a CCP apply before and during the recovery phase.

6.2 The Draft Regulation brings these issues into the resolution phase as it expressly requires resolution authorities to apply a CCP’s rules and recovery plan in full before applying other resolution tools or resolution powers – Article 23(1) requires that:

“I. The resolution authority shall take all appropriate measures to use the resolution tools referred to in Article 27 and exercise the resolution powers referred to in Article 48 in accordance with the following principles:

(a) all contractual obligations and other arrangements in the CCP’s recovery plan are enforced, to the extent that they have not been exhausted before entry into resolution.

(b) the shareholders of the CCP under resolution bear first losses following the enforcement of all obligations and arrangements referred to in point (a) in accordance with that point;” [emphasis added]

6.3 This intention is put into effect by Article 27(3)(a) which requires that:

“3. Prior to the use of the tools referred to in paragraph 1, the resolution authority shall enforce: (a) any existing and outstanding rights of the CCP, including any contractual obligations by clearing members to meet cash calls, to provide additional resources to the CCP, or to take on positions of defaulting clearing members, whether through an auction or other agreed means in the CCP’s operating rules;” [emphasis added]

This point is reiterated in Recitals (38), (42), (43) and (45) by reference to “outstanding contractual obligations” and “other arrangements in its operating rules”.

6.4 Whilst Article 23(1)(a) grants resolution authorities the power to “refrain from enforcing certain contractual obligations under the CCP’s recovery plan or otherwise deviate from it”, whether this occurs in practice is at the discretion of the resolution authority, considering the ability “to achieve the

---

resolution objectives in a timely manner”. There are three factors that are relevant to, and in some cases might incline against, the exercise of this discretion:

(a) These objectives require the resolution authority to consider the possibility of contagion in the financial system. As imposing losses on clearing members may put them in financial distress, this could inform a desire to limit the losses imposed on clearing members at some level.

(b) Though the objective to protect public funds from losses may require losses to be borne in resolution by CCP equity, this must be balanced against the objective to ensure the continuity of the CCP’s critical functions (which must be supported by adequate regulatory capital to meet Article 16 EMIR), suggesting that the primary allocation of losses will fall on clearing members (and possibly also other creditors).

(c) The potential for the resolution authority to be exposed to litigation risk from holders of CCP equity where the resolution authority departs from the NCWO principle, as referenced in Recital (81a), would likely also be taken into account by the resolution authority.

7. ENTITLEMENT TO COMPENSATION

7.1 The Draft Regulation does provide resolution authorities with the power to require CCPs to compensate clearing members in certain circumstances.

7.2 Article 27(5) provides that the resolution authority may require the CCP to compensate non-defaulting clearing members for losses arising from the use of loss allocation tools in resolution with instruments of ownership, debt instruments or instruments recognising a claim on the CCP’s future profits. Whilst not constituting a write-down of equity as such, the use of such instruments would likely have a dilutive effect on the value of existing CCP equity.

7.3 However, that power to require compensation from the CCP is applicable only to losses in excess of those that the clearing members would have borne under their obligations under the CCP’s operating rules.

7.4 This means that the availability of compensation in principle is subject to similar issues to those discussed in the sections above. In particular, it is unlikely that the resolution authority would use loss allocation tools other than those contained in the CCP rulebook, and so the likelihood in practice of “excess losses” being incurred over and above those that clearing members would have borne under the CCP rulebook is low. The corresponding scope for compensation to be directed by the resolution authority is therefore equally low.

8. NO CREDITOR WORSE OFF (NCWO) PRINCIPLE

8.1 The NCWO principle is caveated in a similar manner. The insolvency counterfactual must assume prior full usage of contractual rights available to the CCP.

8.2 Resolution authorities are obliged to apply their powers to CCPs in a manner that respects the NCWO principle. Article 23(1), establishing principles for the application of resolution tools and resolution powers, requires that:

“(e) the CCP’s shareholders, creditors, clearing members and to the extent the information is available, their clients should not incur greater losses than they would have incurred in the circumstances referred to in Article 60 [the NCWO principle]; […]”

---

5 Article 21(1)(c)
6 Article 21(1)(d)
10 Article 21(1)(a)
Article 60, which sets out the NCWO principle, is drafted as follows:

“Where the resolution authority uses one or more resolution tools, it shall ensure that shareholders, clearing members and other creditors, do not incur greater losses than they would have incurred had the resolution authority not taken resolution action in relation to the CCP at the time the resolution authority considered that the conditions for resolution pursuant to Article 22(1) were met and the CCP had instead been wound up under normal insolvency proceedings, following the full application of the applicable contractual obligations and other arrangements in its operating rules.” [emphasis added]

Further, Article 61, which sets out the valuation methodology used to determine the existence of rights to claim under the NCWO principle requires the valuation to be done on the basis that “the CCP had been wound up under normal insolvency proceedings, following the full application of the applicable contractual obligations and other arrangements in its operating rules”.

Article 62, which gives the right to a claim under the NCWO principle based on the valuation prepared in accordance with Article 61 reiterates the restriction established in both Articles 60 and 61.

Therefore, the NCWO principle itself is configured in a way that applies the CCP rules and recovery plan and so limits the losses in resolution left to be borne by CCP equity. It is not at all clear what a hypothetical insolvency looks like for a CCP whose balance sheet would not in fact be insolvent following assumed application of its rulebook – the proceeding would likely be more akin to a solvent wind-down of business. How that assessment is carried out for a CCP with multiple segregated clearing services, where the CCP might retain valuable ongoing services on the closure of the affected service, is even less clear. This approach to drafting does appear to leave open the possibility that equity holders would have a NCWO claim of their own in the event that they were asked to absorb losses which could in fact have been otherwise addressed or allocated by full use of contractual powers available in the CCP rules.

9. RELIANCE & CONFIDENTIALITY

This memorandum is addressed to the International Securities and Derivatives Association (ISDA) solely for its benefit. No other person may rely on this memorandum for any purpose without our prior written consent. In this matter we have taken instructions solely from ISDA.

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. Allen & Overy LLP is a limited liability partnership registered in England and Wales with registered number OC306763. Allen & Overy LLP is authorised and regulated by the Solicitors Regulation Authority of England and Wales.

The term partner is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP’s affiliated undertakings. A list of the members of Allen & Overy LLP and of the non-members who are designated as partners is open to inspection at our registered office at One Bishops Square, London E1 6AD.

Allen & Overy is an international legal practice with approximately 5,500 people, including some 550 partners, working in more than 40 offices worldwide. A current list of Allen & Overy offices is available at allenover.com/locations.

© Allen & Overy LLP 2020. This document is for general guidance only and does not constitute definitive advice.