ISDA® Safe, Efficient Markets

CCP Recovery and Continuity

Presentation to EBA

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Agenda

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Executive Summary

Optimal CCP recovery arrangements provide for:

- Limited liability of guarantors/ members
- Tail losses exceeding limited resources provided by guarantor members are born by those that can control those - trading principles - through unpaid variation margin (VM) gains. Haircutting unpaid VM gains encourages trading principles to provide hedges to the CCP and aggressively bid in default management auctions
- Termination of all contracts or resolution should the CCP Default Management Plan fail.

Introduction

- With mandatory OTC clearing, CCPs will become the most systemically important market participants
- CCPs must establish robust recovery and continuity mechanisms per EMIR and CPSS-ISOCO standards to avoid CCP resolution (or insolvency)
- Once a CCP has (approved) recovery rules in place to cover specific sources of losses, such rules must be respected
- To reduce the systemic risk arising from a CCP failure, clearing members must be able to manage their risk to the CCP.
- CCP transparent rules and processes must be carefully constructed to enable all participants to manage and measure their risks to the CCP. This should apply at any stage of the lifecycle of the CCP, i.e. recovery or resolution.

Relationship between recovery and resolution

- Focus should be firstly on “recovery and continuity” versus resolution
- Recovery arrangements (e.g. VM gains haircutting) must be used only at the end of (i.e., as the last step) the default waterfall.
- There needs to be full respect for/adherence to CCP recovery rules. The arrangements which a CCP makes in respect of recovery are a matter of contract between the CCP and its members. CMs require certainty and transparency in their dealings with CCPs. Accordingly, it is of the utmost importance that these rules are respected by regulators up to the point of non-viability. If resolution is unavoidable, it is imperative that ex ante resolution arrangements are also transparent and predictable.
- CCP resolution should be viewed as a last resort. Resolution is necessarily undesirable so everything reasonable should be done to prevent it but any resolution arrangements must also be transparent and predictable.

A typical CCP default management waterfall structure

Defaulter's resources

Initial Margin (IM)	This might be securities (bankruptcy remote) or cash (not bankruptcy remote). Main "defence" against default (in 99%+ cases IM should be sufficient to cover the loss)
Defaulting clearing member's default fund contribution	Usually cash – defaulter's default fund (guarantee fund) contribution used before those of non defaulting clearing members
Tranche of CCP's capital	Tranche of CCP's capital (CCP 's "skin in the game")
Default fund contributions of surviving clearing members	Default fund contributions of non defaulting clearing members – might be tiered depending on auction results
Assessment s/ unfunded default fund contributions	Most CCPs can call surviving members for an unfunded DF contribution of "x" times the funded amount
Additional CCP capital tranche	Can mitigate moral hazard in which the CCP under-protects cleared positions with either insufficient margins or other waterfall protections because it assumes it will be protected from insolvency
Variation Margin gain haircutting	CCP Recovery Rules - Haircutting of unpaid VM to provide time, if necessary, to complete the CCP default management plan CCP resolution or the default of CCP: In order to reduce the risk of contagion there should be a well defined process for the dissolution of clearing a product on a given CCP (and not across all products on a given CCP)

Mutualised resources

Criteria for CCP recovery arrangements

- Must be predictable and clear
- Must not increase systemic risk and have been approved by regulator
- Must only allow for supervisory intervention when default waterfall is exhausted: we support full service tear-up to avoid contagion, especially in cases where CCP has more than one clearing service. Recovery and resolution enters only if the supervisor, that has approved full contract tear-up as part of rules, has determined nevertheless against it in the moment.
- Must avoid moral hazard, “gaming”, “arbitrage”
- Must encourage participants to help the CCP hedge its open market risk
- Any participant’s loss creates a proportionate share in the CCP’s claim against the defaulted member’s estate
- Recovery (and resolution) arrangements **<u>need</u>** to contain protections for netting and collateral arrangements (refer next slide)
- CCP interoperability seeks to achieve the optimal combination of a virtual single CCP from each user’s perspective while still retaining the benefits of competition. However, interoperable structures must not threaten CCP recovery and resolution rules, CM limited liability provisions or closeout netting rights/enforceability

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Close-out netting must be protected

- Recovery and resolution arrangements should in no way interfere with Clearing Members' close-out netting and set off rights in the in event of CCP insolvency or segment wind-down.
  - In order for banks to be able to report their counterparty exposure to CCPs on a net rather than gross basis, accounting rules require such institutions to obtain an unqualified legal opinion that there is a legally enforceable right to net transactions against CCs. Resolution powers that might impact the availability of such opinions could significantly impact clearing members' regulatory capital.
- Without full protection of close-out netting with a CCP, clearing members are required to gross up their trade exposure to that CCP, leading to potential breaches to single counterparty credit limits.

Non-competitive allocation must be avoided

- Non-competitive, “forced” allocation or invoicing back of defaulting CMs positions must be avoided
- There is no known market clearing price at which to allocate positions. Increases systemic risk by increasing likelihood of further CM defaults
- Because the loss cannot be quantified ex ante, difficult to align with principle of aligning liability to risk control
- A "partial tear up" is simply a another form of forced allocation/invoicing back

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Variation Margin gain haircutting

- VM gain haircutting enables the CCP to complete its auction/ liquidate the inherited portfolio and should be used only if the CCP would otherwise become insolvent
  - If the CCP does not receive any bids in the auction, it would mean that the default management process has failed, and VM gain haircutting should not be applied to cover losses
- VM gain haircutting = wide allocation of losses to CMs, indirect participants and their underlying customers
- CMs and clients can manage the risk of the haircut by reducing their positions as desired - VM gain haircutting encourages them to do so!
- Positions may be entered into with CCP to assist it in flattening its inherited porttfolio

Clearing member liability aligned to risk control

- Even for an uncleared swap trade, bilateral credit risk exposes a firm to potential future exposure driven by changes in market conditions. Clearing does not change that construct. If a member defaults, losses by way of unpaid gains on non defaulting member offsetting positions are not eliminated - the losses don't go away.
- What is essentially different in clearing is the member mutualized resources by way of default fund contributions and further assessments. Provision of mutualised resources by guarantors entails the risk of loss that cannot be actively controlled as it arises from the default of other members, so DF contributions, assessments, etc, must be a limited and known amount.
- Losses incurred on positions which exceed available CCP resources, must be shared by all participants, direct and indirect alike.

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Failure of CCP Default Management Plan

- A CCP's recovery arrangements must be robust enough so that supervisory intervention is unwarranted. DMP of CCP must be fully respected as process represents a contractual agreement between the CCP and its participants.
- However, in the event that the CCP (and/or its members) has failed to perform to the DMP, a service termination or a resolution event would be warranted depending on whether the service is limited recourse or not. This incentivizes members to turn up and bid responsibly in any auction.
- Participants must not be indefinitely compelled to take haircuts on VM gains due to defective or negligent clearing risk management - there must be recourse to contract tear-up/resolution.

EBA’s opinion paper

Opinion of the European Banking Authority on the European Commission’s consultation on a possible framework for the recovery and resolution of financial institutions other than banks, 21December 2012.

- *“initial margin haircutting”* (para 13): IM haircutting distorts segregation and “bankruptcy remoteness”, which are embedded in many aspects of the new regulatory regimes. CCP default management tools that would impact the sanctity of IM would have significant regulatory capital implications.
- *“…banks could be seriously hit if the margin in relation to an in-the-money transaction is haircut, whilst the margin for a corresponding hedging trade that is out-of-the-money is required in full. In our view, more consideration should be given to the specific circumstances of the clearing member and their ability to actually absorb losses”* (para 13) To avoid this, VM gains haircutting applies widely to CMs, indirect participants and underlying customers.
- *“…some of the proposed loss allocation tools could spread the problems to previously non-defaulting members.”* (para 13) Misunderstanding that losses can be avoided by tear up. Tearing up contracts does not escape unpaid gains (equivalently, a haircut to variation gains), for all those with mark-to-market gains. CMs do not necessity want to be subject to contract replacement costs especially when they can manage the risk of the haircut by reducing their positions.