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Avoiding Armageddon: Resolution Regimes for Central Clearing Counterparties

The September 2009 resolutions of the G20 nations at their Pittsburgh summit, as to the compulsory centralised clearing of standardised over-the-counter (OTC) derivatives, paved the way for the creation of some of the biggest too-big-to-fail institutions the financial system has ever contained. Central clearing of securities and financial contracts is nothing new, but this corralling of OTC derivatives gives central clearing counterparties (CCPs) a new prominence and the resulting concentration of counterparty risk has necessitated new, more robust prudential requirements for CCPs.

As a result, in April 2012, the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) published the final version of their principles for financial market infrastructures (FMIs)[1], as well as their proposed disclosure framework and assessment methodology in December 2012[2]. These principles cover CCPs, as well as systemically important payment systems, central securities depositories, securities settlement systems and trade repositories, although this alert focuses on the provisions relating to CCPs.

As repositories of counterparty risk, CCPs have always needed to ensure their own financial resilience by imposing on their participants rules and procedures designed to help the CCP withstand the shock of a default by one or more of its clearing members. Those rules typically include the use of compulsory margin and contributions to default funds, as well as the CCP's own capital, and such measures have traditionally led to many users of CCPs regarding them as effectively risk-free.

In addition, in the U.S. and Europe, Title VIII of the Dodd-Frank Act and the EMIR Regulation, respectively, prescribe binding provisions for CCPs to maintain minimum amounts of capital and other financial resources such as default funds and margins to protect against the risk of a CCP default.

However, extreme market conditions, such as the failure of clearing members of the CCP, a fall in the value of collateral and/or a prolonged period of illiquidity, could still cause the failure of a CCP. This fact was acknowledged in the July 2012 report of the Basel Committee on Banking Supervision (BCBS) on exposures to CCPs. The BCBS now recommends that banks apply a risk-weighting of 2% with respect to their trade exposures to a CCP, so long as that CCP is supervised in accordance with regulations consistent with the CPSS-IOSCO principles for FMIs. Exposures to other CCPs whose supervision is not consistent with those principles would carry higher risk-weightings still under the Basel III framework. Having acknowledged the potential fallibility of

[1] Principles for financial market infrastructures, April 2012, http://www.bis.org/publ/cpss101a.pdf.
[2] Principles for financial market infrastructures: Disclosure framework and assessment methodology, December 2012, http://www.bis.org/publ/cpss106.pdf.

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CCPs, therefore, we look below at the measures proposed, on a global basis and in Europe, to address the circumstances of such a failure, and to limit the resulting disruption to the financial system.

CPSS-IOSCO Principles and FSB Key Attributes Paper

The CPSS-IOSCO principles act primarily as recommended preventative measures to be taken by CCPs to reduce the possibility of failure, including as to its general organisation, its credit and liquidity risk management and its default management procedures. These consist not just of measures such as holding prudent levels of financial resources *ab initio*, but also of having a strategy to replenish resources in a significant stress scenario. The principles also require CCPs to draw up recovery plans designed to identify a range of scenarios that might prevent them from providing their critical services as a going concern and to provide a blueprint for restoring their financial health in such situations. The principles envisage that the execution of these recovery plans should be overseen by the relevant competent authority, who would have express powers to be able to require the implementation of certain recovery measures, including the demanding of information, the issuance of orders to take corrective action (such as making changes to its business model, rules or procedures), and possibly even the replacement of the CCP's management.

However, where the available recovery measures fail to restore the CCP's financial health, policymakers acknowledge that existing insolvency regimes do not cater adequately to the potential failure of FMIs, such as CCPs. This is because the existing regimes do not focus on preserving financial stability as one of the objectives of the regime.

In its Key Attributes paper in October 2011[3], the Financial Stability Board highlighted the benefits of introducing a statutory regime for the resolution of financial institutions, including not only banks and deposit-taking institutions, but also FMIs. In respect of CCPs, such a regime is intended to focus primarily on ensuring the timely completion of the CCP's payment and settlement obligations, even where those obligations fail to be fulfilled on the day on which the CCP enters into resolution proceedings. Such continuity having been ensured, the operation of the resolution regime under the auspices of the relevant resolution authority would then determine whether the CCP could ultimately continue to perform such clearing services as a going concern, or whether its outstanding obligations and positions would need to be transferred to one or more other CCPs.

CPSS-IOSCO Consultation on Resolution of FMIs

In July 2012, CPSS and IOSCO published a consultation paper[4] which set out their views on how the Key Attributes are applicable to a resolution regime for FMIs, in addition to inviting views on certain aspects and principles of such a regime. The paper also highlights certain clarifications and modifications to the Key Attributes needed to make them suitable for FMIs. One of the most obvious of these modifications is the principle of allowing a resolution authority to impose a moratorium on the payment obligations of an institution. Whilst this may be an essential tool for the successful resolution of a bank, it would clearly be antithetical to the primary objective in a resolution of a CCP – that of ensuring the continuity of the CCP's clearing obligations.

Recovery and Loss Absorption

The ability of a CCP to withstand a default by one or more clearing members will depend to a large extent upon its rules and procedures for managing such a default. All CCPs will have a prescribed order (or "waterfall") in which losses are absorbed by different funds available to it. The first losses may be absorbed by margin and default fund contributions from the defaulting member, with default fund contributions and margins of non-defaulting

[3] Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, http://www.financialstabilityboard.org/publications/r_111104cc.pdf.
[4] Recovery and resolution of financial market infrastructures, July 2012, http://www.bis.org/publ/cpss103.pdf.

members being used only to the extent there are still unabsorbed losses. At some point in the waterfall, a CCP may also provide for some of its own capital to be used to absorb remaining losses. However, to the extent there still remain losses to be absorbed, a CCP must also have rules to determine how the remaining losses are allocated.

In addition to the above, the ability of a CCP to recover as a going concern will depend on its ability to re-establish a "matched book", in other words replacing the defaulting members' positions by establishing an auction process to sell long positions to (or buy short positions from) the surviving CCP participants.

To the extent some positions cannot be successfully auctioned (for instance due to the price demanded by participants exceeding the CCP's available funds), an alternative is to terminate and settle in cash (or "tear up") the unmatched positions at a price based on the price used for the most recent posting of variation margin to the CCP.

In the July 2012 consultation, the CPSS and IOSCO acknowledge that tearing up the unmatched positions (as opposed to not holding an auction, and tearing up all positions) would have the effect of altering the aggregate positions of surviving participants as against the CCP, and they invited views on the circumstances in which a tear up is considered an appropriate method of loss allocation in a recovery/ resolution process.

Resolution Tools

In terms of allocation of further losses remaining after the above loss absorption procedures, the CPSS and IOSCO envisage that a resolution authority would need to be able to apply various resolution tools. These would include the power to discount the value of (or to "haircut") the margin held by the CCP and/or enforce any obligations of the CCP participants to meet cash calls or make further contributions to the default fund.

They also consider that a resolution authority should have the power to write off equity invested in a CCP, as well as writing down or converting to equity ("bailing in") the debt obligations (if any) that the CCP may have outstanding.

Separately from its loss-absorption tools, a resolution authority would need legal powers to transfer rights and obligations, either to a third party purchaser or a publicly owned bridge institution prior to an eventual sale or winding up, as well as the ability to impose a temporary stay on the exercise of early termination rights under financial or commercial contracts.

Given the extreme level of intrusion involved in the use of resolution tools in terms of the legal relationship between a CCP and its participants, shareholders and creditors, high levels of clarity are required as to the conditions that must exist before resolution tools can be exercised. In the context of CCPs, CPSS and IOSCO consider that the CCP must be no longer viable (or likely to be no longer viable) and with no reasonable prospect of recovering viability, and they acknowledge in this context that determining appropriate standards or indicators of non-viability will be crucial if a resolution regime for FMIs is to have the confidence of the financial system.

Recovery and Resolution Plans and Co-Operation

In much the same way as for other financial institutions, CCPs would have to prepare recovery plans that would prescribe measures to restore their financial viability, and submit those plans to the appropriate authority. In addition, resolution authorities would need powers to compel disclosure of a broad range of information from CCPs to enable the authorities to prepare resolution plans for use if the recovery initiatives are unsuccessful.

The successful application of resolution plans, though, will require a high level of information sharing and co-operation, not only between authorities in the same jurisdiction, but also on a cross-border basis. As with any multi-jurisdictional resolution process, parochial or protectionist stances taken by individual authorities or

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member states will hinder the objectives of the resolution and therefore finding a way to ensure a consistent application of any resolution regime across borders will be vital to any regime's success.

U.S. CCPs

In the U.S., resolution planning is not currently a requirement for CCPs, and although the Federal Reserve Board has the legal authority to impose such a requirement on designated, systemically important CCPs, it has so far not done so.

In terms of a resolution regime for CCPs, Title II of the Dodd Frank Act has already provided the Federal Deposit Insurance Corporation (FCIC) with orderly liquidation authority over certain non-bank financial institutions, such as CCPs. Under these provisions, the FDIC can be appointed as the receiver of a failing CCP if the Secretary of the Treasury, the Federal Reserve Board and the FDIC determine that its failure would have serious adverse effects on U.S. financial stability. Such an appointment of the FDIC would trigger special powers of the FDIC to resolve the failing CCP, including powers to transfer assets and liabilities to another CCP or to a bridge institution, instead of the application of the standard U.S. bankruptcy or bank receivership procedures that would otherwise normally apply.

European Commission Consultation

In October 2012, the European Commission published its own consultation paper[5] on the recovery and resolution of FMIs, following the CPSS-IOSCO consultation. In the paper, the Commission expresses the following views:

- The primary objective of a European resolution regime for CCPs is ensuring the continuity of critical services.

- Each CCP should prepare recovery plans as a guide to restoring its viability in a situation of extreme financial stress.

- As part of their preparation of resolution plans, resolution authorities should assess the resolvability of the relevant CCP, and should have the power to demand changes in the CCP's operation if necessary to facilitate resolvability. Each resolution plan should dictate how the CCP's resolution can be achieved in the most efficient way, including all information necessary to preserve the CCP's essential functions.

- The trigger point for initiating resolution measures should be the non-viability, or likely non-viability, of the CCP where there is no reasonable prospect of it becoming viable. In addition, it should be a condition that resolution measures should only be applied where the CCP's failure would have systemic implications for other parts of the financial sector.

- Prior to reaching the trigger point for the exercise of resolution measures, for instance, where a CCP breaches its regulatory obligations, authorities could be given certain intervention powers, such as the power to force changes to be made to the CCP's contractual rules and procedures.

- The powers given to resolution authorities should include powers to replace senior management, to transfer assets/liabilities to third party purchasers or temporary bridge institutions, to restructure the CCP's business operations, to recapitalize the CCP by amending/overriding rights of creditors, to override

[5] Consultation on a possible recovery and resolution framework for financial institutions other than banks, October 2012, http://ec.europa.eu/internal_market/consultations/2012/nonbanks/consultation-document_en.pdf.

shareholder rights and to impose a moratorium on the exercise of early termination rights under financial or commercial contracts.

Of these powers, the ability to transfer the CCP's assets/liabilities to another private sector CCP may in principle be the most effective method of resolution, but the Commission acknowledges that finding such a private sector CCP, which is willing and able to take such a transfer at a time of financial stress, would be particularly difficult, given the lack of institutions offering clearing services. Even once such a transferee were found, there would be further difficulties to be overcome, such as the possible incompatibility of operating systems and differences in rules and procedures between the two CCPs. For these reasons, the power to make a temporary transfer to a public bridge institution would be essential, as an interim measure while attempting to address such issues. The European Banking Authority, in its opinion on the European consultation, advocated establishing advanced arrangements to facilitate the transfer of clearing members and positions in a resolution scenario, such as setting up a centralised repository for all CCP membership agreements, standardising clearing documentation and providing for draft transition services agreements as part of resolution plans.

Loss Reallocation

Having stabilised the CCP through the use of one or more resolution powers, the Commission envisages the following possible methods of absorbing and allocating the losses of the CCP with the aim of restoring it as a going concern:

1. An application of haircuts to initial margins. These resources would be readily available to a CCP, although, if used, they would need to be replenished by liquidity calls on clearing members. In addition, the possibility of such hair cutting would need to be factored into initial margin requirements on an ongoing basis, which could result in initial margin increases, making it more expensive for members to transact business.

2. An application of haircuts to variation margins. The intention here is that some or all of an out-of-the-money clearing member's margin would be applied to absorb losses, instead of being posted through to the corresponding in-the-money clearing member. While the Commission highlights the advantage of using money that is available and already anticipated by the relevant out-of-the-money clearing member, concern must remain that the relevant in-the-money clearing members would then not receive the variation margin they had anticipated receiving.

3. Specific liquidity calls on CCP members. Here, the Commission envisages powers to make ad-hoc liquidity calls on all clearing members simultaneously, thereby avoiding issues of random loss allocation. However, limited information on the mechanics of how this might operate in practice have been provided at the consultation stage.

4. Requiring CCPs to enter into an 'ex-ante insurance mechanism'. The primary advantage here would be that additional funds would be provided in advance of any financial stress, avoiding any procyclical effect, but this would prove an inefficient use of resources unless the required levels were properly calibrated and could be efficiently managed/invested.

5. Converting debt of CCPs to equity. The Commission envisages CCPs issuing debt instruments which would be convertible into equity upon resolution and would have the advantage of not placing the liquidity burden of a failing CCP onto the market participants (thereby potentially exacerbating the problem). However, traditionally CCPs do not issue many debt instruments, so it remains to be seen how useful this option will be.

6. Terminating contracts. Referred to primarily "as a last resort", the Commission has suggested that the resolution authorities could be allowed to tear up those contracts of the defaulting party which the CCP cannot liquidate (see "Recovery and Loss Absorption" above).

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Clearly the decision to implement any of items 1, 2, 3 or 6 above could have wide-reaching implications for the market, given that such measures almost certainly have the potential to amplify the risk of contagion. That said, such risks would need to be balanced against the potentially expensive utilisation of crisis funding via debt and insurance instruments (see items 4 and 5), which will no doubt ultimately increase the cost of transacting business for all participants, even in a healthy market.

Cross-Border Resolution

The Commission recognises that for CCPs with presence in multiple jurisdictions, effective co-operation between different resolution authorities is crucial to address the effects of a CCP resolution beyond its home country, and it proposes the formation of supervisory colleges, consisting of different national resolution authorities and the European Supervisory Authorities (EBA, ESMA and EIOPA), who would fulfil a mediation function between the different authorities, as and when required. The Commission also proposes the use of bilateral cooperation agreements to ensure cross-border co-operation, as well as a cross-border regime for the recognition of decisions made by overseas resolution authorities. Achieving these goals within the EU is one thing, but it is likely to be several years before such a cross-border cooperation and recognition regime is realised between the EU and other jurisdictions.

UK CCP Resolution Measures

Whilst the UK will be bound to implement the legislation that is eventually enacted at the EU level, in the meantime, the UK Treasury has focused on the need to provide the regulatory authorities in the UK with resolution powers over UK CCPs, and does not propose to wait for the EU discussion and legislation process. Having consulted on resolution regimes for financial sector entities, including CCPs, in August 2012, the UK Treasury has now introduced certain resolution measures in the Financial Services Act 2012, which was published on 20 December 2012 and will come into effect as provided in one or more commencement orders to be published shortly by the Treasury. When in effect, this statute will, among other things, amend the provisions of the Banking Act 2009, which was implemented following the failure of the Northern Rock Building Society, and introduced for the first time a special resolution regime (SRR) for banks and certain other financial institutions. The Financial Services Act 2012 will extend the operation of the SRR to CCPs.

The extended resolution regime will cover CCPs which have their head office or registered office (or both) in the UK, and which are Recognised Clearing Houses under Part 18 of the Financial Services and Markets Act 2000 (FSMA 2000). However, the extended SRR will only apply to such CCPs that are considered systemically important. The analysis of systemic importance in this regard will be undertaken by the Bank of England, which will be the resolution authority in respect of UK CCPs.

The threshold conditions for the exercise of stabilisation powers by the Bank of England in respect of UK CCPs will be that the CCP is failing, or likely to fail, the FSMA 2000 requirements for recognition and, having consulted with the Treasury (and, if the CCP is also authorised by the new Prudential Regulation Authority (PRA), the PRA), the Bank of England concludes that it is not reasonably likely that the CCP will be able to maintain the continuity of its clearing services.

Thereafter, the stabilisation options available to the Bank of England are to make an order transferring the shares of the CCP to any person, and to make orders transferring all or part of the business (property, rights and liabilities) of the CCP to a private sector purchaser or to a Bank of England owned temporary bridge institution. However, the Bank of England must first be satisfied (having again consulted with the Treasury and the PRA if the CCP is PRA-regulated) that such exercise is necessary, and in the public interest, to the stability of the UK's financial systems.

The Bank of England will also be able to direct a UK CCP to take or refrain from taking, a wide range of actions where necessary to preserve financial stability and maintain continuity of clearing services.

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In order to ensure continuity of clearing functions, any stabilisation action effected by the Bank of England under the regime would not trigger default or similar provisions under any existing contracts of the CCP.

As is the case with UK banks under the existing SRR, secondary legislation is expected to be enacted by the Treasury to provide for safeguards for certain property rights. In particular, this should cover the situation where some, but not all, of the CCP's property, rights and/or liabilities are transferred, including the possibility of compensation arrangements to ensure that creditors are not unduly prejudiced by the stabilisation action.

Next Steps

As the baskets, into which a huge number of eggs, in the form of OTC derivatives, will soon be placed, CCPs clearly have to be sufficiently robust to be able to withstand a certain level of financial stress. However, since no advance prudential requirements can ever guarantee that a financial institution will not fail, even more vital are appropriate regimes to plan for the possibility of the failure of one or more systemically important CCPs and how to address such failure with the minimum of disruption to the financial system and with the minimum possible effect on taxpayers.

In Europe, based on indications from the European Securities and Markets Association, it is expected that the first compulsorily clearable OTC derivatives under the EMIR Regulation may be required to enter clearing through CCPs in the summer of 2014. That does not leave much time for European jurisdictions to finalise and put in place effective resolution regimes for these entities.

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