Institutional Investor

VOL. XXII, NO. 8 / February 25, 2013

Exclusive Insight for Derivatives Buyers, Sellers and Structurers

Derivatives Week

The weekly issue from **Derivatives Intelligence**

www.derivativesintelligence.com

Protecting The CCP Egg Basket

*By **Jeremy Jennings-Mares** and **Peter Green**, partners at **Morrison & Foerster***

As the basket into which trillions of dollars worth of eggs, in the form of OTC derivatives, must eventually be crammed, central clearing counterparties have the potential to become the world's biggest too-big-too-fail institutions.


Jeremy Jennings-Mares


Peter Green

The implementation of EMIR and the Dodd-Frank Act will mutualize large volumes of counterparty risk and, together with new requirements for trade reporting, will afford regulators a clearer view of where systemic risk is building up. However, following the taxpayer-funded bailouts of large parts of the banking industry, policymakers are increasingly focusing their attention on measures designed to decrease the likelihood of a major CCP failure and, more importantly, to ensure that when a CCP does fail, it causes minimal disruption to the financial system and minimal cost to taxpayers.

The **Committee on Payment and Settlement Systems** and the **International Organisation of Securities Commissions** have released proposed principles for financial market infrastructures, such as CCPs, containing recommended prudential measures for CCPs, covering their structure and organization, their management of credit and liquidity risk and procedures for managing clearing member defaults. In addition to measures such as the holding of adequate levels of financial resources *ab initio*, CCPs are required to develop strategies to replenish resources in a significant stress scenario.

The principles also prescribe the preparation of recovery plans by CCPs, designed to identify the potential scenarios that might prevent them providing their critical services, and also to provide a strategy for restoring their financial health in such situations. The plans would be submitted to national resolution authorities, who would oversee their implementation in a stress scenario and would have express powers to require the implementation of certain recovery measures, to demand information and to issue orders to make changes to the CCP's business model, rules or procedures, as well as to replace the management of the CCP.

But if the financial resources available to the CCP prove insufficient to cope with the failure of one or more of its clearing members and implementation of the recovery plan fails to restore its financial viability, policymakers have recognized, in the same way as for banks in 2008, that existing insolvency regimes are not suited to an orderly resolution of a CCP. Existing insolvency regimes that would apply to CCPs do not primarily focus on preserving financial stability as one of their core objectives.

As a result, the CPSS and IOSCO reached for the paper published by the **Financial Stability Board** in October 2011, Key Attributes of Effective Resolution Regimes for Financial Institutions, and in July 2012 published their consultation paper, Recovery and Resolution of Financial Market Infrastructures setting out their views on adapting and applying the FSB's Key Attributes to non-bank financial market infrastructures, such as CCPs. For example, in a standard financial stress/resolution scenario, one of the most important attributes of an effective resolution regime is the ability for authorities to impose a temporary moratorium on the institution's payment obligations, while implementing other resolution measures. However in respect of CCPs, the primary focus has to be the timely completion of the CCP's payment and settlement obligations and therefore, the imposition of a payment moratorium will be contrary to the primary objective of a CCP resolution.

Crucial to the ability of a CCP to survive a default by its clearing members are the measures and procedures it implements for managing such a scenario. In terms of loss absorption, each CCP will prescribe a pecking order in which any losses are to be absorbed by the different funds available to the CCP. Typically the first loss relating to the default of the clearing member will be absorbed by specific margin or collateral provided by the defaulting member, as well as by contributions to the general default fund maintained by the CCP. After the clearing member-related loss has exhausted the funds provided by that clearing member, there can be variations (as between different CCPs) between the order in which remaining losses are absorbed by the funds available to a CCP, but the available funds will include initial and variation margin provided by non-defaulting clearing members, as well as the contributions of such members to the CCP default fund, and in addition the CCP's own capital funds. They may also include additional unfunded contributions to the default fund resulting from calls on such members.

However, to the extent that funds prove insufficient, the CCP must have robust rules to determine how remaining unabsorbed losses are allocated. To survive as a going concern, a CCP would have to re-establish a matched book by holding an auction process to replace the defaulting member's positions. For those positions not successfully auctioned, a possible alternative solution is to terminate and settle in cash, or "tear up", the unmatched positions at a price based upon the most recent valuation used for the posting of variation margin. The inherent problem with this, though, is that it in effect constitutes a forced allocation of losses on to surviving participants, as opposed to the alternative of spreading the loss more evenly, via a full tear up of all the defaulting member's positions, without holding an auction.

In October 2012, the European Commission published its own consultation paper on the recovery and resolution of financial institutions other than banks, broadly echoing the measures in the CPSS/IOSCO July 2012 proposals, in particular, which invited comments on the following methods of allocating the unfunded losses of a CCP:

Haircutting initial margin--initial margin is readily available to a CCP, though if used would need to be replenished from liquidity calls on clearing members. The possibility of such haircutting would have to be factored into a CCP's initial margin requirements on an on-going basis, leading to increases in those requirements and making derivatives clearing more expensive;

Haircutting variation margin--some or all of the variation margin of an out-of-the-money clearing member would be applied to absorb losses, instead of being posted through to the corresponding in-the-money clearing member. Again, the funds are available and the haircutting does not add to losses anticipated by the out-of-the-money member, though of course the in-the-money member will then not receive the variation margin it had anticipated;

Specific ad hoc liquidity calls on all CCP members simultaneously--this has the advantage of avoiding random loss allocation, but exacerbates contagion due to clearing members having to contribute unanticipated funds at a time of financial stress;

Requiring CCPs to enter into an *ex ante* insurance mechanism--since additional funds would be provided in advance of any financial stress, this would avoid creating a procyclical effect, but could represent an expensive and inefficient use of resources;

Bailing-in of CCP debts--the ability of resolution authorities to compel the writing-off of debt issued by a CCP or its conversion into equity instruments. This avoids placing the burden of loss onto the CCP's participants, and thus exacerbating the problem. However, many clearing members may also be the holders of debt issued by the CCP, and in any case, CCPs tend not to issue much debt, so it is unclear how useful the bail-in option would be;

Tearing up the contracts of the defaulting clearing member--the Commission views this as primarily a last resort. ISDA advocates a full tear-up, rather than a partial tear-up, to avoid contagion by spreading losses fairly.

While waiting for a pan-European CCP resolution regime, the U.K. has introduced CCP resolution powers, via the Financial Services Act 2012, by extending the banks' special resolution regime in the Banking Act 2009 to recognized clearing houses which have their head office or registered office in the U.K.

Under these provisions, where a UK CCP is failing, or likely to fail, to meet the requirements for recognition under the U.K.'s Financial Services and Markets Act 2000 and the **Bank of England** concludes that it is not reasonably likely that the CCP will be able to continue providing clearing services, a wide range of stabilization options and resolution powers are available to the BofE, including making an order transferring the shares of the CCP to any person, or transferring all or part of the business of the CCP to a private sector purchaser or to a BofE-owned temporary bridge institution.

For a CCP with presences in many jurisdictions, the co-operation of the various regulators will be essential to its orderly resolution. Within the EU, supervisory colleges are proposed, consisting of different national resolution authorities as well as the EBA, ESMA and EIOPA, who would fulfill a mediation function. In terms of relations between the EU and non-EU jurisdictions, the Commission proposes putting in place bilateral agreements to ensure cross-border co-operation, and envisages the development of a cross-border regime for the mutual recognition of decisions made by overseas resolution authorities.

Judging by the progress of equivalent resolution regimes for banks (such as pursuant to the draft Resolution and Recovery Directive in Europe), substantial amounts of time and perseverance are going to be required to achieve these measures for CCPs.