Update on CCP Clearing
The CCPs' perspective

2nd Annual Post Trade Forum

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European Association of CCP Clearing Houses (EACH)

Agenda

1.- G20 commitment

2.- Clearing obligation

3.- Recovery and resolution

4.- EMIR review

The G20 commitment

G20 leaders agree to promote CCP clearing of OTC derivatives

The power of 81 words

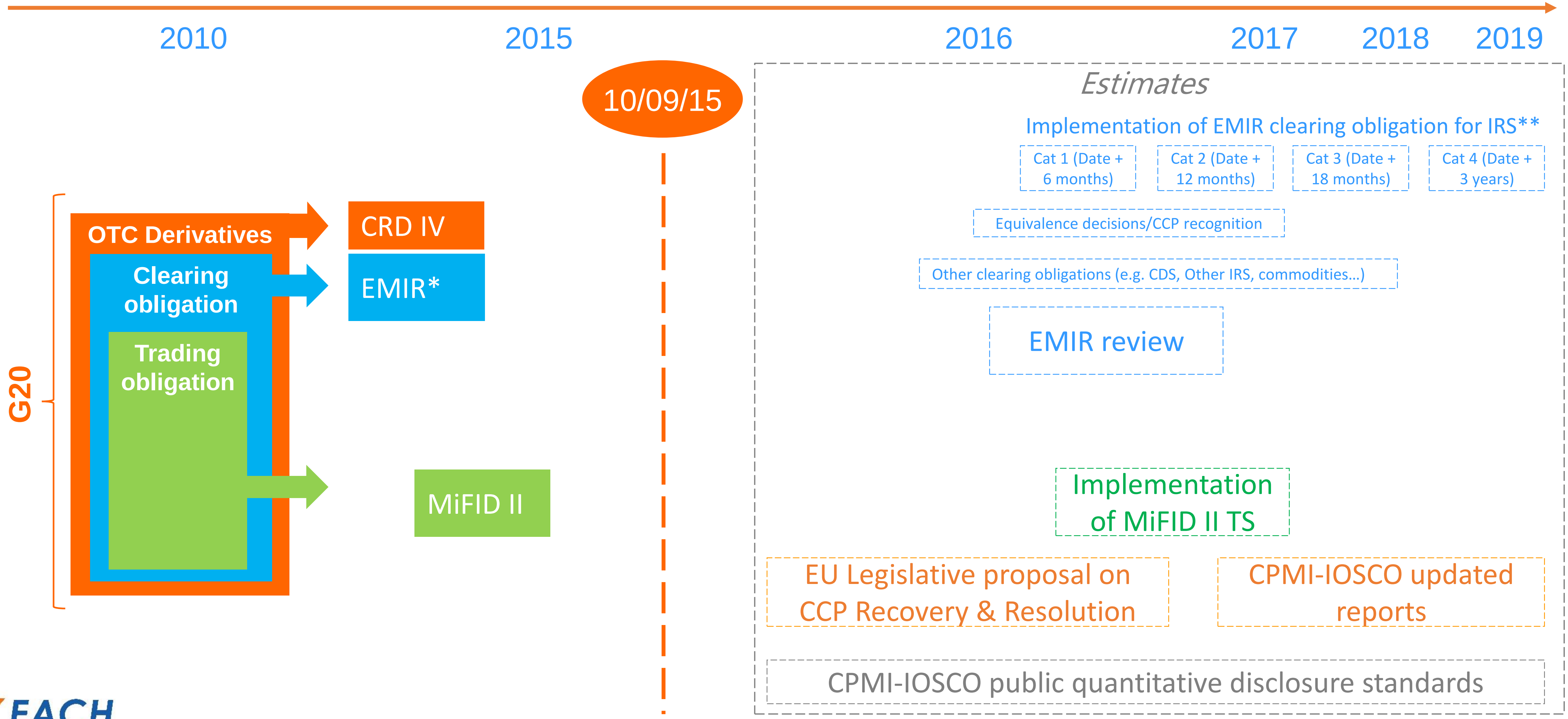
Efficiency

Transparency

Improving over-the-counter derivatives markets: All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

Risk Management

Summary of key legislative initiatives on CCP clearing post-G20



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* EMIR also includes a requirement for derivatives to be reported to Trade Repositories

** See next slide for exact scope

Clearing obligation (CO)
Scope of the first CO in the EU – Interest Rate Swaps (IRS)

Products		
Type	**Currency**	**Maturity**
Basis swaps	EUR, GBP, JPY, USD	28 days to 50 years (30 years for JPY)
Fixed-to-float	EUR, GBP, JPY, USD	28 days to 50 years (30 years for JPY)
Forward rate agreements	EUR, GBP, USD	3 days to 3 years
Overnight index swaps	EUR, GBP, USD	7 days to 3 years

Organisations subject to the IRS clearing obligation		
	Who	**Threshold**
Category 1	Clearing members	None
Category 2	Financial counterparties or Alternative investment funds (AIFs) which are NFC+	> EUR8bn threshold*
Category 3	Financial counterparties or Alternative investment funds (AIFs) which are NFC+	< EUR8bn threshold*
Category 4	NFC+	Not Cat. 1, 2 or 3

16 EU CCPs authorised*

6 EU CCPs authorised for IRSs

* Source: www.esma.europa.eu

** Non-financial counterparties that clear above a certain threshold

CCP's lines of defense

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CCPs can successfully deal with members' default

- Some CCPs have successfully been clearing OTC derivatives for years.
- CCPs clear standardised OTC derivatives only, which are liquid, easy to price and therefore safe to clear
- The Lehman bankruptcy demonstrated that CCPs can cope with the default of a large member active in OTC derivatives

Use of CCP's waterfall during Lehman's bankruptcy by the largest CCP

Risk management

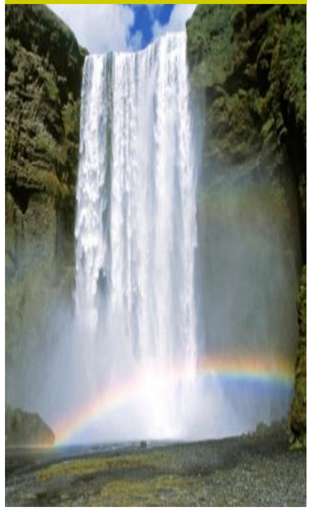
1.- MARGINS – Variation margin defaulting clearing member

2.- MARGINS – Initial margin defaulting clearing member

3.- DF - Defaulting clearing member DF contribution

4.- CCP's skin-in-the-game

5.- DF - Non defaulting members pre-funded contributions + other pre-funded contributions



35%

Only 35% of Lehman's US$ 2 bn initial margin used

0

No use of default fund or CCP's own resources

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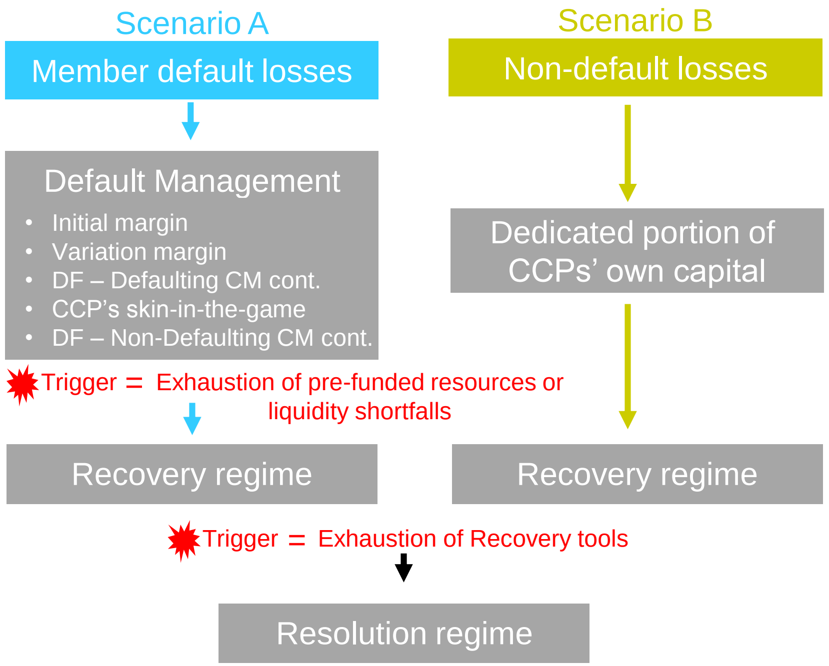
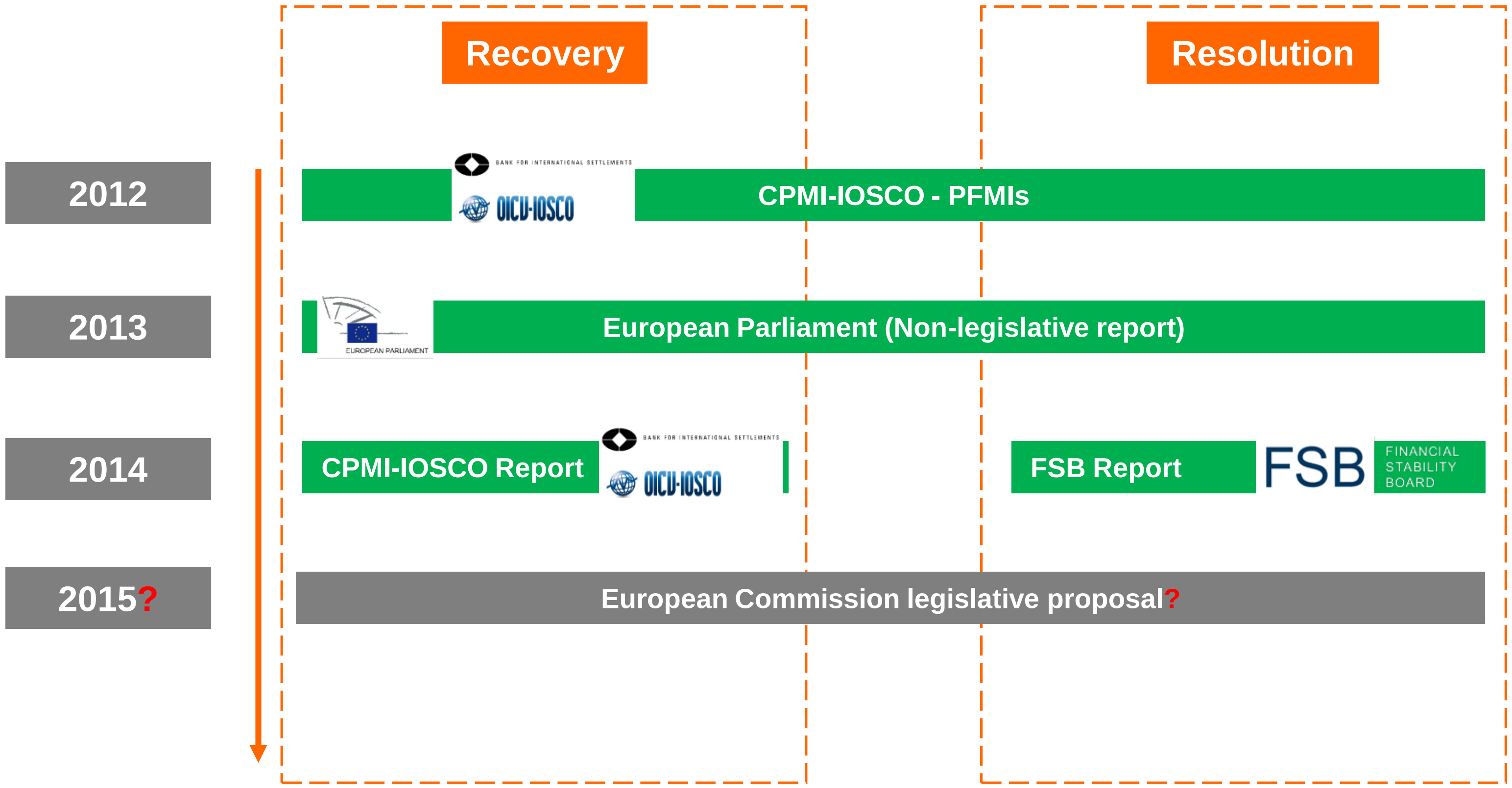
Recovery and Resolution of CCPs – Ready for Armageddon

Recovery and Resolution of CCPs – Scenarios



DF: Default fund
CM cont.: Clearing member contribution

Recovery and Resolution of CCPs – Guidelines and legislation



Recovery and Resolution of CCPs – Key principles

- Structure - CCPs should be allowed to implement their recovery plan before resolution authorities intervene
- Transparency - Recovery tools should be agreed ex ante, transparent, predictable
- Flexibility - CCPs should retain flexibility to implement tools that work best for their markets and products
- Fairness - CCPs should be able to allocated losses to all participants

Objective

Continuity of the CCPs’ critical services without having recourse to public funds.

Recovery tools

Type of tool	In place at some CCPs	Adequate for	Characteristics
1.- ASSESSMENT POWERS Additional contributions from participants	Yes	Any product	Size of contribution is relative to the participant's contribution to the pre-funded default fund. Contributions are not pre-funded but members could chose to set aside capital on their books for this contingency. Typically callable immediately from clearing members in cash in a liquid currency.
2.- VARIATION MARGIN (VM) HAIRCUTTING/PROFIT CROPPING Reduction in the net VM gains / profits due to the non-defaulting members	Yes	OTC derivatives Listed Futures & Options	The defaulter's VM losses/losses are distributed to all clearing members and clients with net VM gains/profits and not to all clearing members Different types of contracts are subject to varying methods of haircutting/cropping e.g. mark to market, contingent, profit and loss flows. VM haircutting or profit cropping may be effected differently by different CCPs. Unless capped, the retroactive cumulative sum of clearing participants' VM gains/profits since a participant's default will always be sufficient to cover the defaulter's mark-to-market losses in the same period. How haircuts are applied to customers may vary per CCP and depends on the contractual arrangements between the clearing members and the customers.
3.- LOSS DISTRIBUTION Sharing the defaulter's VM losses across the non-defaulting clearing members	Yes	Any product	Under loss distribution, the defaulter's VM losses may be distributed across all clearing members, usually in proportion to the risk they pose (i.e. by default fund contribution, or initial margin), and not just those clearing members with positive VM, such as for VM haircutting and profit cropping.
4.- ALLOCATION OF POSITIONS The CCP closes member positions in a specific asset class/market segment at prices it can make	No	Any product	If the CCP has positions with uncovered losses, it terminates these positions towards the members that has made a gain. This should be done pro-rata, effectively shrinking a members' exposure to the asset class/market segment of the market where there is a loss that the CCP cannot cover with its resources.
5.- TEMPORARY CLOSURE The CCP legally closes all contracts early, at price X. On some later day, all the contracts are mandatorily re-opened, except those of the defaulted clearing member, at price Y	Yes	Any product	Any safeguards such as the maximum loss that can be allocated to clearing members through this method should be pre-determined. Challenges around determining the re-open price.
6.- PERMANENT CLOSURE All positions in the particular clearing service are terminated irrevocably at a price chosen by the CCP	Yes	Any product	Allows members to stop supporting a particular clearing service that may have become undesirable because of the nature of the crisis. Other 'healthy' clearing services can continue.

Resolution tools

Type of powers	Characteristics
1.- RECOVERY TOOLS	The resolution authority may decide to use the recovery tools described in Table 1. In practice, a resolution authority can extend, re-use, or modify any of the asset increasing or liability reducing tools as required.
2.- INITIAL MARGIN HAIRCUTTING	Initial margins are not intended to be used to cover losses other than those incurred by the participant who posted them. While using initial margins could help resolve a CCP under some circumstances we recognise that it would undermine the concept of 'bankruptcy remoteness'.
3.- TRANSFER TO THIRD PARTY	It is an effective tool as long as it is possible to obtain new assets or reduce liabilities when applied. It is likely to be easier between CCPs with overlapping membership and products. Such CCPs may be similarly affected by the severe conditions which caused the CCP failure. Even if this were not the case, it may be difficult for a CCP to prepare to accept the transfer of open interest from what is likely to be a broken market. Resolution authorities should be able to effect such transfer without the consent of the failed CCP, but not without the consent of the viable CCP to which the contracts are to be transferred and its regulators. Transfer of business from one CCP to another may raise the following challenges: • Complexity in transferring positions and collateral • Amending clearing member's agreement. • The receiving CCP obtaining all the necessary information for performing adequate risk management (e.g, calculate margins) by • Maintaining connectivity with the regulated market/CSD • Potential conflicts of law if the receiving CCP is located in a different jurisdiction
4.- FORCED RECAPITALISATION/RECAPITALISATION FUND	Forced recapitalisation by shareholders is inconsistent with the principle of 'no creditor worse off' than in insolvency and would lead to shareholders paying to save the CCP participants' positions, Shareholders would, however, be expected to contribute what they can in recovery attempts. Recapitalisation funds which assume control/equity in a CCP also pose a conflict of interest, as the participants of CCPs might not support a default management to acquire the CCP.
5.- CONVERSION OF OUTSTANDING DEBT INTO EQUITY	Not a relevant tool for CCPs since they do not generally issue debt.
6.- STAY ON MEMBER'S TERMINATION RIGHTS	A stay on members' termination rights could be counterproductive. The mere threat of such a stay could be sufficient to incentivise termination by clearing members prior to the resolution phase, which would hinder the resolution of the CCP.
7.- MORATORIUM OF PAYMENTS BY CCPs	Generally not desirable. In certain circumstances, however, putting in place such a moratorium, a temporary suspension of the market or "false weekend" may be appropriate. Such moratorium should not be extended to interoperating CCPs to avoid contagion.

EMIR review

Question time!

Do you think EMIR II is needed?

EMIR review

Authorisations

- Articles 15 and 17 - Process for extending activities and services
- Article 49 - Authorisation of changes to a CCP's risk management. What is deemed 'significant'?

Portfolio margining

- Article 27 RTS 153/2013 - To support a safe and efficient model for portfolio margining provided that:
  - CCP is able to demonstrate that its margin model is sufficiently robust even when correlations may not be significant nor reliable.
  - CCP can demonstrate that the group of financial instruments to be portfolio margined can be hedged as one portfolio of risk during a default and/or auctioned in a reasonable period of time (as applicable), consistent with the liquidation process.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EACH views on portfolio margining

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- EMIR provides a good basis to ensure safe and efficient risk management through CCP clearing.
- An efficient fixing of some key areas would be preferred from a CCP perspective.

Thank you!

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