

18<sup>th</sup> June 2020

**'Let's make markets safer, not weaker'**

**An EACH note on CCP Recovery and Resolution**

The market turmoil generated by the impact of **COVID-19** has once again recalled the importance of ensuring safe and robust financial markets. With some European stock market indices experiencing rapid falls that were amongst the largest ever (or the largest) observed in similar crisis period in the history of indices<sup>1</sup>, CCPs have shown once more their resilience to extreme market moves and the robustness of their risk management set up under EMIR to ensure the protection of the economy as a whole, and importantly the protection of taxpayers.

**EACH generally welcomes what we understand is the compromise proposal of the Croatian Presidency.** We believe this is a carefully crafted compromise that tries to square the many circles of this long-lasting discussion, addresses the main concerns of all stakeholders involved and largely preserves financial stability.

We understand that the intention of regulators and legislators with the legislative proposal on CCP Recovery and Resolution is to make markets safer and more resilient. To ensure this objective is met, **EACH would like to make some clarifications on what we understand is the compromise proposed by the Croatian Presidency:**

- 1. Public funds** – EACH supports the proposals of the European Parliament and the Council of the EU to strengthen the language and include a recoupment mechanism from all CCP stakeholders in the legislation in order to avoid the use of taxpayers' money. In the event where public funds would still have to be used as stabilisation tool, the recoupment mechanism would help limit the moral hazard dimension. We therefore support a compromise between the Council and the Parliament texts.
- 2. Compensation linked to the NCWO principle** – Compensating clearing members for any tool beyond the CCP rulebook would create a perverse incentive for clearing members to reduce the amount of tools (which are not compensated) in the CCP rulebook, thereby weakening recovery and making resolution more likely. This not only

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<sup>1</sup> Between 1st February 2020 and 1st April 2020, FTSE 100 lost 25.14% of its value, IBEX 35 lost 29.77% while FTSE Italia all shares lost 28.58%. A similar scenario could be observed in France and Germany, with CAC 40 losing 27.44% of its value and DAX losing 26.48%.

weakens the CCP's risk management but also increases the possibility of hitting taxpayers.

To ensure robust risk management and further protect taxpayers, **we welcome the compromise proposal of the Croatian Presidency to combine the positions of the European Parliament and the Council with a strong No-Creditor-Worse-Off (NCWO) safeguard**, as compensation would only be granted to clearing members if they are worse off in resolution than in insolvency. EACH notes that this is consistent with all international standards and existing practice in other jurisdictions.

- 3. 2<sup>nd</sup> Skin-in-the-game (SIG) has not been justified** – The European Commission did not include it in its original proposal, the ESMA Stress Tests never suggested this was needed and neither did the European Parliament in its EMIR REFIT work, where the CCP's prudential requirements like the SIG were discussed. The recent turmoil on financial markets have shown that CCPs have resilient risk management and a 2<sup>nd</sup> SIG is not needed to 'align incentives' which the current EMIR framework is already ensuring. Some stakeholders are using as a justification a recent paper by two BIS economists<sup>2</sup>; this paper clearly states that it does not represent the views of the BIS and clarifies in a footnote that, contrary to other jurisdictions, European CCPs are already subject to a regulatory requirement on SIG.

A 2<sup>nd</sup> SIG would likely diminish the competitiveness of EU CCPs compared to the rest of the world without making them safer, potentially increase the cost of clearing and putting additional heavy and unnecessary strain on smaller CCPs without any risk concern to justify it. It could in turn reduce CCP overall resilience, as CCP membership could see more of their losses subsidised by the CCP and their incentive to maintain a strong default waterfall would be reduced.

In the spirit of compromise, **EACH supports the Croatian Presidency's proposal to add a 2<sup>nd</sup> layer SIG at the beginning of recovery without the obligation to prefund it and to introduce proportionality for the smaller CCPs, thereby mitigating the negative impact of a prefunded SIG.**

- 4. Lockdown should happen after full default fund exhaustion, not before** – EACH is of the opinion that, given the strict regulations European CCPs are subject to (e.g. authorisation, independent expert validation, constant consultation, supervision and monitoring by supervisory boards, risk committees, NCAs, colleges as well as ESMA), potentially long-term restrictions such as a 5 years lockdown on payment of dividends, buybacks or variable remuneration are not necessary.

However, in the spirit of compromise, EACH could support the proposal by the Croatian Presidency to introduce a lockdown period, provided that such period would start after the full exhaustion of the default fund, once recovery is triggered, and does not last more than 2 years.

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<sup>2</sup> Model risk at central counterparties: Is skin-in-the-game a game changer?: <https://www.bis.org/publ/work866.pdf>

5. **Variation margin gains haircutting (VMGH)** – CCPs should retain the flexibility of determining the amount, type and sequencing of tools best fit for their markets in cooperation with their clearing members and clients and with the approval of their NCA. While EACH does not oppose preparations for the possible use of VMGH in resolution, it is important that it is framed appropriately given other preferred tools in recovery or other features of the market. We would suggest clarifying that where this tool is to be used in resolution it should be at the sole discretion of the resolution authority. If VMGH is to be used as a recovery tool, it should be at the sole discretion of the CCP in line with the rulebook agreed with the clearing members. Finally, EACH stresses that not all markets or CCPs use VMGH, and in agreement with their regulators and participants employ other comprehensive loss allocation tools, and that VMGH is not suitable or desirable for all markets.

In addition, we would warn against attempts to be too specific on how VMGH works in practice. Getting into the details of how VMGH works, even in a recital, could have unintended consequences on the current practice of CCPs. We would therefore suggest avoiding specific descriptions of the tool in the Level 1 text.

6. **NDLs to be shared among those responsible for them** – While we welcome that the CCPs' capital is mainly used to cover NDLs as indicated by EMIR, **EACH strongly suggests that the compromise reflects that other stakeholders than CCPs may be responsible for those losses, as indicated in the CPMI-IOSCO Guidelines<sup>3</sup>**. We would therefore suggest to include in the compromise the Recital 20a of the Parliament text according to which, as a general principle, "losses should be distributed between CCPs, clearing members, and their clients as a function of their ability to control the risks" and "loss allocation also for non-default losses should be proportional to the level of responsibility of each stakeholder involved".
7. **No-Creditor-Worse-Off (NCWO) counterfactual** – EACH recommends that the NCWO counterfactual describing a CCP insolvency should be broad enough to balance the flexibility of the resolution authority to act in resolution and the protection of clearing members.
- EACH therefore supports the extension of the NCWO counterfactual to include the sum of CCP rulebook + insolvency proceedings + replacement costs, as proposed by the Croatian Presidency. This counterfactual can be estimated (see Appendix) and adjusted during the NCWO process, in line with the procedure of NCWO claims in other EU legislation (e.g. BRRD) and consistent with the Key Attributes established at international level by the FSB.
8. **Resolution cash call** – EACH is in favour of the introduction of a cash call reserved for the resolution authority for resources in resolution. However, this resolution authority cash call should be *in addition to*, not instead of, the tools already existing in the CCP

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<sup>3</sup> CPMI-IOSCO 'Recovery of financial market infrastructures', July 2017: <https://www.bis.org/cpmi/publ/d162.pdf>

rulebook. Moreover, EACH would call for caution on capping available resources in resolution, which would limit the flexibility of the resolution authority and deviate from the internationally agreed CPMI-IOSCO/FSB standards. EACH is therefore in favour of a compromise between the Council and Parliament texts.

- 9. Recovery plans for groups** – CCPs are by nature established to be independent and have their own fully collateralised risk profiles. Imposing group-wide recovery plans would question this independence and create contagion risks between CCPs and FMIs of the same group without clear benefits. We therefore support the proposals of the European Parliament and Council not to require group recovery plans and rather ensure if necessary that CCPs take group structures into account in their recovery plans.
- 10. CCP equity shareholders are exposed to losses** – Contrary to what some private stakeholders argue, the potential for CCP shareholders to exercise claims against the resolution authority is minimised, as the counterfactual would in European jurisdictions include the write-down of the CCP shareholder's equity under normal insolvency proceedings. Similarly, in resolution, EACH has always been supportive that CCP equity be written down, as an appropriate incentive on the CCP.

In line with the overall objective of CCPs, the above suggestions are aimed at preserving robust risk management and ultimately protecting taxpayers. We hope regulators and legislators will also work towards this aim.

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## Appendix 1 – The calculation on the NCWO principle

The NCWO counterfactual base would automatically take into account:

- The CCP's default waterfall;
- The CCP's recovery tools; and
- The losses and costs of closing the CCP (e.g. closure of positions, the replacement cost of reopening positions either with a different CCP or in the bilateral market, liquidating the CCP through normal insolvency procedures in line with local requirements, etc.).

The **calculation** of the potential losses that would result from the above would be straightforward: the default waterfall and the recovery tools are predefined in the CCP's operating rules. The losses and costs of closing a CCP should be easily calculated as derived from the existing costs of clearing at the CCP plus an add-on to account for the replacement costs. These losses and costs would have the following components:

- In case of transferring to another CCP:
  - The cost of **reopening positions** with another CCP (e.g. membership fees, contribution to the new CCP's default waterfall, bid/ask spreads, adverse price moves, potential technological/IT adjustments).
- In case of reopening positions in the bilateral market:
- The cost of additional **capital and margin requirements** that bilateral contracts would be subject to (e.g. higher capital requirements than the 2% to 4% related to CCP exposures; VM is no longer netted out by limited recourse; IM charges from client to clearing member and also from clearing member to clients). Several pieces of research have analysed the estimated quantitative impact of transitioning from a cleared environment to a bilateral one.
- The cost of **replacing the client accounts in the CCP** with positions directly with the clearing member. This cost arises due to the lack of netting benefits related to omnibus accounts.
- The cost of closing the **clearing members accounts** with the CCP. This cost arises in case there are offsets between positions in the house account of the clearing members. If this is the case, margin benefits will be removed as a result of closing positions with the CCP.

As an alternative to the transfer to another CCP or reopening positions in the bilateral market, a clearing member may also decide to no longer enter into positions requiring clearing.