EACH Response to the HMT Consultation "Expanded Resolution Regime: Central Counterparties"

May 2021

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Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparties (CCPs) in Europe since 1992. CCPs are financial market infrastructures that significantly contribute to safer, more efficient and transparent global financial markets. EACH currently has 19 Members from 15 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

EACH appreciates the opportunity to provide feedback to the HM Treasury consultation paper "Expanded Resolution Regime: Central Counterparties"[1].

EACH responses to the consultation questions

Question I – Do you agree with the proposed scope of our NCWO safeguard and counterfactual?

EACH agrees with the proposal of introducing an explicit NCWO safeguard in the CCP resolution regime, with a transparent counterfactual that is consistent with the FSB guidance[2]. In this regard, we are of the opinion that the NCWO counterfactual should be broad enough to **balance the flexibility** of the resolution authority to act in resolution and the protection of clearing members, and should therefore include the **sum of CCP rulebook + insolvency proceedings + replacement costs**. We believe that a good example of how to ensure such balance is provided, for instance, by the **EU CCP Recovery and Resolution (EU CCP RR) Framework**[3].

EACH therefore invites the HM Treasury to take into consideration the provisions included in **Article 61** of the EU CCP RR Framework, according to which the valuation of the counterfactual, i.e. the treatment that shareholders, clearing members and other creditors would have received had the resolution authority not taken resolution action and had the CCP instead been wound up under normal insolvency proceedings, should:

- **disregard** any provision of extraordinary **public financial support** to the CCP under resolution or central bank emergency liquidity assistance provided under non-standard collateralisation, tenor and interest terms;
- be based on the **losses** that would have been **realistically incurred by clearing members and other creditors**, had the CCP been wound up under normal insolvency

[1] Expanded Resolution Regime: Central Counterparties, HM Treasury, 12 February 2021: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/962168/Expanded_Resolution_Regime_for_Central_Counterparties_-_Consultation__002_.pdf

[2] Key Attributes of Effective Resolution Regimes for Financial Institutions, FSB, 15 October 2014: https://www.fsb.org/wp-content/uploads/r_141015.pdf

[3] Regulation (Eu) 2021/23 of the European Parliament and of the Council of 16 December 2020 on a framework for the recovery and resolution of central counterparties: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0023&from=EN

proceedings following the full application of the applicable contractual obligations and other arrangements in its operating rules;

- take into account a **commercially reasonable estimate of the direct replacement costs**, including any additional margin requirements, incurred by the clearing members to reopen within an appropriate period their comparable net positions in the market by considering effective market conditions, including market depth and ability of the market to transact the relevant volume of such net positions within that period; and
- be based on the **CCP's own pricing methodology** unless such methodology for price determination does not reflect the effective market conditions.

Regarding the reasonable estimate of the replacement costs referred to above, EACH believes it can be performed by using the **initial margin** requirement as a proxy. The rationale behind this proposal is that when a clearing member needs to enter a replacement transaction, the cost of this transaction will depend on two components:

- the net risk of the transaction;
- the current volatility and liquidity in the underlying product (the "market conditions").

It is naturally difficult to anticipate with full certainty the market conditions of a situation where three or more of the largest clearing members have failed, the CCP is closed and all contracts are terminated. However, as described below, the initial margin requirement provides a **good proxy for the costs incurred in 99% of the cases** because the cost of replacement is linked to the overall risk. In other words, replacing trades in a CCP insolvency is very risky and hence very expensive.

As the initial margin requirement seeks to calculate the collateral necessary to cover potential liquidation costs during adverse market moves in the expected closeout period (2 days for ETD, 5 for OTC), it provides a good assessment of the risk of the portfolio, but also of the expected impact on the pricing of the portfolio in extreme, yet plausible scenarios. We believe that this approach has **two main benefits**:

- the initial margin is calculated on the basis of **how much it would cost to liquidate a portfolio in at least 99% of the cases** (confidence level of 99.5% for OTC Derivatives and 99% for ETD). Referring to initial margin requirement as a proxy would therefore represent a very conservative approach and rather serve as a threshold as from which could enter NCWO counterfactual territory, so should be hopefully acceptable;
- the calculation of the initial margin requirement is done under strict regulatory standards and based on the risk models of the CCP, with which **clearing members agree through the rulebook**; it is therefore foreseeable and known by the clearing members in advance.

Question II – What factors should be taken into account when calculating the quantum and position in the default waterfall of the second tranche of SITG?

It is EACH's opinion that there is **neither quantitative nor qualitative justification for introducing a second tranche of skin in the game (SITG)**. As mentioned in the consultation paper, under the current regime and in line with the EMIR legislation[4], UK CCPs – like the EU ones – dedicate to the default waterfall an amount of own resources, i.e. the skin in the game (SITG), equal to at least 25% of the regulatory capital.

The consultation paper suggests that the proposed second SITG would lead to a greater amount of capital for loss absorption. EACH would however like to highlight that the purpose of the SITG is **not to absorb losses**, but to incentivize the CCP to perform prudent risk management. As mentioned above, there is **no reason not to consider the current calibration of SITG as adequate** because it is proportionate to the size of the CCP, reflects the role of the CCP as risk manager rather than risk taker and is calculated on the capital that covers the risk that the CCP is responsible for. Neither the European Commission during the review of the EMIR legislation nor ESMA when performing stress tests have ever suggested that the current calibration of the SITG of EU CCPs may not fulfil its purpose.

Based on a survey run through EACH Members in 2020[5], an **increased amount of CCP own resources** to be dedicated in the form of second SITG would **not affect the incentives of the CCP operator** to ensure strong risk management. It would rather lead to the CCP **subsidizing some of the default losses that CCP members may be responsible for** due to them not actively participating in the default management phase (e.g. auctions). The SITG is indeed the primary incentive for CCPs to perform robust risk management. In order to serve this purpose, the amount of SITG must be **high enough to "hurt" the CCP** should it be exhausted during the default management process. We believe this is already the case with the first SITG.

In addition, we would like to highlight that the current standard to which UK CCPs are subject to of SITG being at a minimum equal to 25% of regulatory capital is one of the most **stringent internationally**, as for instance legislations in United States, Japan, Australia and Canada are silent as regards a minimum amount of SITG that a CCP must dedicate, and do not foresee at all any second tranche.

However, should the UK Authorities decide to impose a second tranche of SITG, EACH agrees with para. A.52 that risk-based capital requirement would be an appropriate benchmark for calculating the quantum of the SSITG. In addition, EACH would recommend ensuring a **level playing field** with the provisions included in Articles 9(14) and 9(15) of the **EU CCP RR Framework**, which foresee that the amount of second SITG shall be **within a range of 10% and 25% of the CCP's risk-based capital** and its calibration shall take into account a series of **factors** such as:

- the structure and internal organisation of the CCP and the nature, scope and complexity of their activities;

[4] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN
[5] https://www.eachccp.eu/wp-content/uploads/2021/01/EACH-Paper-Carrots-and-sticks_How-the-skin-in-the-game-incentivises-CCPs-to-perform-robust-risk-management-January-2021.pdf

- the structure of incentives of the shareholders, management and clearing members of CCPs and of the clients of clearing members;
- the rules applying to and the practices of third-country CCPs.

EACH would like to stress that if the UK recommends a second SITG, its amount must be carefully considered for the following reasons as discussed above:

- The **structure of incentives** that CCPs already have in place, in our view, adequately promotes robust risk management by the CCP operator and incentivises clearing members to efficiently cooperate with the CCP for the benefit of the system. Requiring CCPs to dedicate an excessive amount of additional own resources is therefore from our point of view not productive;
- An excessive amount of additional own resources would put UK CCPs – especially those that are very active internationally (e.g. swaps market) – at a disadvantage in the international landscape and **damage their competitiveness** since, as mentioned above, UK CCPs already comply with one of the strictest and most robust requirements worldwide.

Finally, EACH believes that a potential second tranche of SITG should be – again in line with the EU CCP RR regime – **covered by existing CCP resources** by employing the additional amount of capital that CCPs hold, in line with EMIR Article 16(3), on top of the minimum capital requirements (the so called **"10% EMIR buffer"**).

EACH also agrees with the proposal in paragraph A.50 to place the second SITG **after the prefunded default fund, but before cash calls**, so that it is used before non-prefunded resources, as this ensures a level playing field with the EU CCP RR that foresees the same provision.

Question III – Do you agree with the proposal to limit the statutory VMGH power to default loss scenarios, and instead have a larger cap on the cash call for non-default-loss scenarios?

EACH **agrees** with the proposal of **limiting the statutory VMGH power to default loss scenarios**, giving to the resolution authority the power of using the VMGH subject to the NCWO counterfactual.

In addition, EACH **agrees** with having a **larger cap on the cash-call** for non-defaulting clearing members, provided that does not impact the right of the CCP to introduce recovery cash calls in its rulebook.

Question IV – Do you agree with the proposed power to delay the use of resolution tools for up to 18 months and its current scope?

EACH agrees with the proposed power to delay the use of resolution tools for up to 18 months and its current scope. We believe indeed that such power could benefit the objectives of resolution and avoid adverse effects on financial stability.

Question V – Do you agree with the modalities of the proposed compensation process?

EACH is generally in favour of the modalities of the compensation scheme proposed in the consultation document in paragraphs A.83 to A.96, and strongly supports the aim of the proposal of **protecting public funds**, leaving their use as a very last resort. We also particularly support the provisions included in paragraph **A.96**, which specify that "*clearing members and CCPs should be responsible for negotiating between themselves the precise nature of any contractual arrangement which would entitle clearing members to a claim on future profits or equity*".

However, we would like to underline that we **oppose any form of compensation that goes outside the limitations posed by the NCWO principle**. Paragraph **A.97** states that the Bank can decide to use equity and future profits to compensate clearing members also in cases where clearing members have not been left worse off than under the NCWO counterfactual, independently of whether an agreement was made contractually or not. The rationale presented is that compensating clearing members might encourage a faster and more voluminous return to clearing and normal market behaviour and therefore promoting financial stability. EACH believes that on the contrary, a compensation scheme **decoupled from the limitations posed by the NCWO** principle would be **detrimental for the incentives structure** on which a CCP is based, as clearing members may be incentivized not to efficiently cooperate with the CCP in the default management process or the recovery phase in order to reach as quickly as possible the compensation stage. This would not only "shift the burden" from the risk takers (i.e. the clearing members) to the risk managers (i.e. the CCP), but would also risk to weaken financial stability, as a result of weakening the incentives of clearing members to participate in the default management.

It is also very important to underline that a compensation mechanism beyond what was contractually agreed by the CCP and the clearing members, not limited by the NCWO principles, may open the way to a **parallel track for compensation** of non-defaulting clearing members, **exposing the resolution authority to possible unlimited claims** – outside the quantum "rulebook + insolvency proceedings + replacement costs" – by the non-defaulting clearing members. This could **potentially put public funds at risk**. The prospect of being compensated in resolution could also incentivize the clearing members to negotiate a "smaller" rulebook in order to be compensated for losses covered by any resources outside of it. This would weaken the existing risk management framework provided by CCPs and, consequently, reduce financial stability and therefore increase the possibility of having recourse to public funds.

In addition, concerning the forms of compensation proposed in paragraph A.92, EACH would like to underline that dedicating an **excessively high portion of CCP profits** to be shared with clearing members dedicated **for too many years** would most likely **endanger the commercial viability** of CCPs, taking away resources that should be dedicated to the ongoing risk management and making the CCP **less attractive** to other investors and potential shareholders. We therefore suggest that compensation should be **limited** both in terms of maximum amount of profits to be shared with the clearing members and in terms of maximum amount of years (e.g. **no more than 25% of CCP profits for no longer than 5 years**).

Question VI – What lead in time would be appropriate for industry to prepare for the new regime? Are there any elements of the new regime that would not require a lead in time?

EACH is of the opinion that, since the UK regime seems to propose a regime very similar to the EU one, and in order to ensure the maintenance of a level playing field in the European market, having similar transitional periods would allow CCPs, clearing members and clients sufficient time to prepare for the new regime and respective changes in the rulebook.

More specifically, we suggest that the timeframe should be applied as and when the Bank of England has finalised the methodology for the calculation and maintenance of the amount of the CCP's own resources that should be included in the second tranche of SITG:

- A **24-month lead time** would be appropriate for a smooth accumulation of the **capital necessary to provide the second tranche of SITG** in order to avoid having to resort to ad-hoc capital injections which could take away resources from planned service enhancements/improvements;
- A **12-month lead** would be appropriate to successfully finalize the rulebook adaptations to reflect HMT's statutory powers in relation to **VMGH, cash calls and compensation** that would require extensive changes in a CCP's risk governance framework and would also regulatory filings.

Question VII – Do you have any other thoughts on the proposals that you would like to bring to our attention ?

EACH would like to receive clarifications concerning how the UK Resolution Regime will be applied to **third-country jurisdictions** and in particular to third-country CCPs operating in the UK. In this context, we would like to suggest that the final text clarifies that third-country CCPs are to be considered out of scope and would only be expected to adhere to their home jurisdiction Recovery and Resolution frameworks.