

CCP Recovery and Resolution: How to avoid pro-cyclicality and increased systemic risk in distressed markets?

CEPS-ECMI Conference Report

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The use of central counterparties (CCPs) has increased markedly in recent years. The decision to shift from bilateral to central clearing of standardised, over-the-counter derivatives has had the effect of concentrating risk in a couple of CCPs. This effect has potentially negative effects on the financial sector and the broader economy in the unlikely event that a CCP fails. The main features of the CCP recovery and resolution framework that has been devised to avoid these negative effects were the topic of debate at the CEPS-ECMI Conference on CCP Recovery and Resolution, hosted by ABN AMRO Clearing in Amsterdam.

Opening remarks

Speaker: **Boudewijn Duinstra**, ABN Amro Clearing

A recovery and resolution framework is the missing element in the CCP legislation. The failure of Lehman Brothers almost a decade ago showed the shock-absorbing capacity of CCPs. Indeed, the CCPs did rather well in resolving the inventory positions of the investment bank. Regulators noticed the shock-absorbing capacity of CCPs in stressed markets and gave them a pivotal position in the post-crisis financial infrastructure. Whilst making the overall financial system more robust, it also enhances the systemic importance of the CCPs. The legislative puzzle for CCPs should therefore be completed with a recovery and resolution mechanism.

The European Commission's proposal for a recovery and resolution framework should address these risks, resolving distressed CCPs in an orderly manner without resorting to the use of taxpayers' money. Two elements are critical for the credibility of this framework: i) the distribution of the losses from the resolved CCP and ii) the coordination of the resolution activities.



Session I. Who should cover the losses in the event of CCP resolution?

Speakers: **Patrick Pearson**, European Commission; **Stephen Fisher**, BlackRock; **Willem Sprenkeler**, Optiver; and **Jan Bart De Boer**, ABN AMRO Clearing

Moderator: **Karel Lannoo**, CEPS/ECMI



There is a widespread consensus that the 'polluter' should pay in the event that a CCP fails. The polluter in the case of a CCP would in general be the CCP members if the failure of the CCP is caused by the failure of one or several of the members or the CCP itself when there is a non-member default (e.g. cyber-attack). The main issue, however, is that the polluters are unlikely to be able to pay in case of default. This fact makes it all the more important that resilience and proper incentive schemes for the CCPs and members are sufficiently prudent. Besides capital requirements and an assessment of risk management, there also needs to be sufficient transparency surrounding the riskiness of the various parties involved to allow for risk-based pricing. The CCPs could further be

made less systemically relevant by enhancing the interoperability (i.e. the possibility to switch) between the CCPs that currently often have a *de facto* monopoly in the clearing of specific products.

Most participants in the debate see room to enhance the resilience of the involved parties. But since CCPs are operating in a global market, they also want the legislation to be in line with the international and US approaches, which would substantially limit the room for strengthening their resilience in the short-term in the EU. In fact, the available default funds at EU CCPs are currently already prepared for bigger catastrophes than in the US.



In order to ensure that the critical activities of systemically important CCPs can be continued in both default and non-default events, other parties will need to cover the losses. But the legislation should at least ensure that the equity of the CCP is first used to cover the losses, although this is not guaranteed in the current proposal. The European Commission's proposal gives the resolution authorities several options for distributing the remaining losses in the case of CCP resolution, such as cash calls and variation margin gains haircuts (VMGH).

The VMGH is in particular a concern to investors/end-clients of CCPs that run a balanced book such as market-makers, i.e. all the positions are hedged across CCPs. Hence, in stress situations, the net positions remain limited, but the gross positions, as the potential gains, will be very large. When the market-maker's gains at one CCP are subject to a haircut and the other loss-making side of the hedge remains unaffected, the market-maker might end up with a large loss that it is unable to cover. The VMGH has a further disadvantage in that only a small share of the investors will absorb the losses. They might even be worse off than in the case of liquidation, which would be a violation of the no creditor worse off (NCWO) principle in the proposed legislation.

An alternative to collecting funds from the end-clients would be to apply a haircut on the initial margins. These funds, however, are widely regarded as belonging to the client and in many jurisdictions – including in the EU (under EMIR) and in the US – it is illegal or even a criminal offence to use them for any purpose other than to cover the (potential) losses from the transactions of their clients.

There are also some concerns about the consequences of loss allocation for clearing members and end-clients. More specifically, how the loss-sharing and compensation for the contributions (e.g. equity, debt certificates, future revenues) affect the incentives for CCPs, members and end-clients. The aim is to avoid runs on the CCPs in cases of stress as well as moral hazard.

Disclosure of the resolution plans is another sensitive point. The regulators and supervisors have to find the right balance between predictability for the end-clients on the one hand and flexibility for legislators in resolution on the other hand. For example, it might be necessary to publish only the summary of the resolution plans. The limited information might lead to uncertainty among the CCP members and end-clients, which would like to use the plan to determine the potential loss and compensation.



Finally, the failure of a CCP is likely to be an extreme event. At those unusual times, it cannot be excluded ex ante that there is no need for taxpayers' money or central bank liquidity to guarantee the operation of the critical activities of CCPs at all times. Nevertheless, there is some disagreement on whether this should be arranged in the current framework or only arranged when the need occurs to avoid moral hazard, i.e. enhanced risk-taking due to insurance. The potential involvement of public funds as well as the potential conflicts of interest make most participants want the supervisors or resolution authorities to decide on the distribution of the losses.

Session II. Will resolution colleges be equipped to resolve CCPs?

Speakers: **Ron Berndsen**, De Nederlandsche Bank & Tilburg University; **Elisabeth Ledrut**, Single Resolution Board; **Demetria O'Sullivan**, ICE Clear Europe; **Cora van Nieuwenhuizen**, Member of the European Parliament (VVD/ALDE)
Moderator: **Karel Lannoo**, CEPS/ECMI



The Commission's proposal foresees a pivotal role for resolution authorities in the resolution framework. Together with other authorities, such as the resolution authorities and supervisors of both the CCP and its clearing members, they gather in the resolution colleges to coordinate the preparation and execution of the CCP resolutions. The Commission's proposal very much follows the international work of the International Organization of Securities Commissions and the Financial Stability Board. All the CCPs, including the ones with a banking license, are covered by the proposed resolution framework.

There is a broad consensus that it will be very challenging to make the resolution colleges work effectively. Supervisory colleges are already large, but resolution colleges are even larger (involving ministries, competent authorities, resolution authorities, etc.). Some authorities can perform multiple roles, which makes the effective number of institutions smaller. Despite huge inefficiencies, the large colleges might work under normal circumstances, but they are unlikely to work once the CCP enters into resolution. Hence, creating the resolution colleges is quite cumbersome, but to some extent a necessary evil in order to reach a joint decision. This is easier when there is a legal obligation to cooperate, but may no longer be the case for the authorities in the UK after Brexit.

Experience with the banking crisis has shown that when decisions need to be taken on resolution, the group should be substantially smaller than the envisaged full CCP resolution colleges. The number of persons taking the decisions in case of an acute crisis should not exceed six to seven, in order to be efficient. The speed with which professional market participants respond to market developments makes it essential that the supervisors and resolution authorities intervene even faster in the event that a CCP is failing or is likely to fail than in the case of a bank failure.

Given the lack of experience with CCP resolutions using colleges and their complexity, it will be essential to regularly conduct simulations. In these simulations as well as in the resolution scheme itself, there needs to be sufficient flexibility. In the past, regulators and supervisors were not able to foresee all the potential crisis scenarios, which, in the view of some observers, might also be a reason to pursue a more principle-based approach than the currently foreseen rule-based approach.



Agenda

- 09:30 – 10:00 **Registration and coffee**
- 10:00 – 10:15 **Welcome remarks**
Boudewijn Duinstra, ABN AMRO Clearing
- 10:15 – 11:30 **Session I - Who should cover the losses in case of CCP resolution?**
The Commission's proposal gives the resolution authorities several options for distributing the remaining losses in the case of CCP resolution, including cash calls and variation margin gains haircuts (VMGH). Although this may avoid implicating taxpayers' money, it may also change the behaviour of CCPs, their members and clients of the CCP members. How would the resolution losses be best covered? Should the creditor waterfall be further restricted or expanded? Is there a need for ex-ante disclosure of the waterfall?
- Patrick Pearson**, European Commission
Stephen Fisher, BlackRock
Willem Sprenkeler, Optiver
Jan Bart De Boer, ABN AMRO Clearing
- Moderator: **Karel Lannoo**, CEPS/ECMI
- 11:30 – 12:45 **Session II - Will resolution colleges be equipped to resolve CCPs?**
The proposal foresees a pivotal role for resolution authorities in the resolution framework. Together with other authorities such as the resolution authorities and supervisors of both the CCP and its clearing members, they gather in the resolution colleges to coordinate the preparation and execution of the CCP resolutions. Are resolution colleges an appropriate entity for timely and coordinated (cross-border) actions in resolution? Do these colleges have sufficient powers and means for effective resolution? Is the resolution framework Brexit-proof?
- Ron Berndsen**, De Nederlandsche Bank & Tilburg University
Elisabeth Ledrut, Single Resolution Board
Demetria O'Sullivan, ICE Clear Europe
Cora van Nieuwenhuizen, Member of the European Parliament (VVD/ALDE)
- Moderator: **Karel Lannoo**, CEPS/ECMI
- 12:45 – 13:00 **Wrap up & closing remarks**
- Karel Lannoo**, CEPS/ECMI
Jan Bart De Boer, ABN AMRO Clearing
- 13:00 – 14:00 **Sandwich lunch**