AmCham EU's position on Central Counterparties Recovery and Resolution

Executive summary

The American Chamber of Commerce to the European Union (Amcham EU) membership is comprised of firms that access Central Counterparties (CCPs) directly and bear potential losses at the CCP (so-called 'clearing members') and those that access CCPs indirectly, or clients of clearing members. AmCham EU takes a keen interest in ensuring the stability of financial markets as a prerequisite to promoting economic growth and jobs in Europe. AmCham EU is supportive of European rules aimed at improving CCP resilience, recovery and resolution. This paper sets out recommendations to further enhance the framework.

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AmCham EU speaks for American companies committed to Europe on trade, investment and competitiveness issues. It aims to ensure a growth-orientated business and investment climate in Europe. AmCham EU facilitates the resolution of transatlantic issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Aggregate US investment in Europe totalled more than €2 trillion in 2016, directly supports more than 4.5 million jobs in Europe, and generates billions of euros annually in income, trade and research and development.

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Introduction

Central counterparties (CCPs) are playing an increasingly important role in financial markets. A key component of the G20's post-crisis reform agenda is mandating the use of CCPs for the clearing of all standardised, bilaterally traded derivatives contracts (referred to as "over-the-counter" (OTC) derivatives). As a result, legislations such as EMIR in Europe and Dodd-Frank's Title VII in the US have led to significant volumes of OTC derivatives to be novated to CCPs. As of the second quarter of 2016, 83.9% of the average daily notional value of interest rate derivatives were centrally cleared, compared with only 57.7% in 2013[1].

A CCP reduces credit risk between two trading counterparties by interposing itself between parties to a derivatives transaction, whereby the CCP becomes the buyer to every seller and the seller to every buyer. The use of CCPs creates numerous benefits for market participants and the financial system by providing for centralised risk management and processing, as well as risk reduction through collateralisation of trades and multilateral netting.

However, as regulation has created a dramatic increase in the number of transactions channelled into central counterparties, risk has concentrated in a small number of large, global CCPs which have arguably become among the most systemically important types of any systemically important financial institution ("SIFI").

We should also recall that although new rules now mandate that market participants must clear OTC derivative trades through them, CCPs are not public utilities. In fact, CCPs are corporations with an incentive to generate profit for their shareholders and, thus, have incentives to generate as much business as possible while maintaining low costs.

AmCham EU believes it is important to ensure CCPs are sufficiently resilient to withstand significant losses, that they have adequate plans in place to recover from such losses, and that if they cannot recover, that they have adequate plans for an orderly resolution that will provide for the provision of critical services without causing market instability or resorting to taxpayer assistance. Most CCPs themselves recognise that they are nodes of systemic risk, and a number of CCPs have accomplished important work in recent years to improve their resilience and governance which should be recognised. Still, there are important areas where regulation is warranted in order to improve prudent risk management and the overall safety of CCPs.

AmCham EU supports the efforts of policymakers across the globe to improve the resilience and ensure continuity of CCPs, including the European Commission's recently published 'Regulation on a framework for the recovery and resolution of central counterparties'.

[1] http://www2.isda.org/functional-areas/research/research-notes/

Work by global regulatory bodies (namely the FSB and CPMI-IOSCO) is still ongoing and incorporating future work into the EU framework will be important. Still, AmCham EU is pleased that the global work completed thus far has been reflected in the European Commission's proposals and that there is a commitment to incorporate future work in the framework. Furthermore, we believe the European Commission took the correct approach in not including equivalence provisions in the Regulation. Indeed there are no equivalence provisions included in the Bank Recovery & Resolution Directive (BRRD) or other resolution regimes. What is important in resolution, and what the Commission has focused on in its proposals, is ensuring effective cooperation between resolution authorities in different jurisdictions.

While supportive of the European Commission's proposals, there are areas where AmCham EU feels the rules could be enhanced to provide for a more robust framework for CCP recovery and resolution. In summary, the rules could be improved in order to:

- **Safeguard financial stability** – Some recovery and/or resolution tools involve allocating losses to clearing members and their clients during times of severe market stress. It will be crucial to ensure that these tools are calibrated appropriately and used under extreme caution as last resort measure so as not to exacerbate instability in financial markets.

- **Improve incentives for CCPs** – Equally important is ensuring that recovery and resolution regimes do not lead to moral hazard by potentially allocating losses to clearing members and their clients (the customers of CCPs) before CCPs and their ownership suffer losses. CCPs need to commit skin-in-the-game to ensure they have strong incentives to manage risk appropriately on behalf of their clients. There should be a mechanism to compensate clearing members or their clients for any losses incurred through a recovery or resolution; certainly customers of CCPs should be compensated before shareholders or other creditors of the CCP.

These are discussed below in greater detail.

Recovery and resolution tools

The draft Regulation rightly sets out a number of tools and powers that CCPs (during a recovery process) and resolution authorities (when a recovery plan has been deemed ineffective and the CCP is put into resolution) can utilise to mitigate systemic crisis. There are instances where the use of certain tools, in recovery or resolution, could in fact negatively impact financial stability or worsen a crisis situation. Furthermore, if not designed carefully, recovery tools could lead to moral hazard within CCPs. In this respect, recovery tools can and should be designed in order create appropriate incentives for CCPs to manage risk properly. Many of the tools considered in the Regulation would allocate losses to non-defaulting participants of the CCPs – clearing members and their clients. We comment on these so-called 'loss allocation' tools here.

- *Initial margin haircutting (IMH)*: AmCham EU does not support initial margin haircutting (IMH) at any point, either in recovery or resolution. Initial margin is the collateral that is posted to a CCP

by a clearing member in respect of its clients' or its own proprietary transactions in order cover any possible losses in case it were to default. IMH would use a portion of the cash collateral of non-defaulting clearing members as a loss absorption resource. In this respect, IMH would allow a CCP to allocate losses to its customers in order to remain solvent. IMH would likely exacerbate market stress and have a destabilizing effect on financial markets. Were a CCP, with ability to haircut IM, having problems, clearing members would have an incentive close out positions in order to reduce their initial margin requirements; this could then hasten the collapse of the CCP or lead to fire-sales in other asset classes should clearing members feel the need to 'top-up' initial margin. Furthermore, clearing members could seek to post non-cash collateral in the place of cash collateral which could lead to a liquidity strain within a CCP. Most policymakers have recognised the potential destabilising effects of IMH. The European Commission, quite rightly in our view, has not included IMH in its list of proposed resolution tools set out in Chapter IV of the Regulation. While this is helpful, **AmCham EU would welcome a provision in the text to *explicitly rule out* the use of IMH both as a recovery and resolution tool. Accordingly, we would recommend that Title II Section 1 on Recovery Planning and Section 2 on Resolution Planning should be amended to explicitly prohibit IMH.**

- *Variation margin gains haircutting (VMGH)*: Variation margin constitutes cash paid on a daily basis to secure or settle changes in the market value of cleared transactions. AmCham EU feels that VMGH should only be used in a very limited way, once there is certainty that the positions can be rebalanced and losses crystallised. Furthermore, it should only be used with the utmost caution as an interim measure to avoid a payment default, provide resources for loss absorption and allow time for recapitalisation of the CCP as a last resort measure. To the extent that there are insufficient funds to cover the loss amount, participants whose positions have been torn up or who have otherwise enabled the CCP to return to a matched book, should be provided with a claim for the deficiency. **Where the European Commission's proposal envisages the possible use of VMGH by a CCP as a recovery tool, some AmCham EU members believe that it should be limited only to resolution after other resources have been depleted, including an appropriately-sized CCP own capital, strictly under administration of a resolution authority and limited to a period of one or two days. Others feel that it is an effective loss allocation tool that facilitates a CCP-led recovery, provided that it is subject to strict regulatory oversight and constraints (e.g., quantitative limits) determined on an ex-ante basis. We feel Article 48(1)(n) should be amended to restrict the use of VMGH to a very limited period.**

- *Partial tear-ups (PTUs)*: Partial tear-up involves terminating some clearing participants' contracts with cash settlement and leaving contracts of other clearing participants' in force (note that full tear-up would involve termination of all contracts). PTUs should be a last resort tool to re-establish a matched book at CCP when other tools have failed. If there are insufficient funds available in the default waterfall to pay the termination amount in full, then participants should be provided with a claim for the deficiency. **AmCham EU feels that PTUs should only apply to the fewest number of illiquid contracts possible while recognising the possible need to broaden the scope of contracts affected; however, this should be subject to strict rules set out and disclosed to clearing participants *ex ante*. Furthermore, the administration of PTUs should**

be subject to oversight of an impartial authority. Further work should be conducted to ensure that price determination reflects a fair market price rather than the CCP simply using the last settlement price.

- *Forced loss allocation*: Recital 52 of the draft Regulation stipulates that resolution authorities should have powers to forcibly allocate defaulters' positions to non-defaulting clearing members. **AmCham EU strongly opposes the use of forced allocation as it could require clearing members to take on positions that they may not be suited to risk manage in extreme market conditions. Use of PTU with proper regulatory oversight is the most appropriate means to rebalance the CCP to a matched-book and leaves no need to retain forced allocation. We would therefore recommend deletion of provisions related to forced loss allocation from Recital 52.**

- *Resolution authority cash calls*: Finally, the draft Regulation stipulates that resolution authorities should have powers to call on non-defaulting clearing members to make a contribution in cash to the CCP up to an amount equivalent to their contribution to the CCP's default fund as a resolution measure. AmCham EU does not support the implementation of a resolution authority cash call. We firmly believe that such cash calls would be pro-cyclical and disproportionately burden the smaller community of clearing members. Furthermore, in a situation where multiple clearing members (either four largest members, or many smaller members) have defaulted, the credit and liquidity impact in the market (both OTC and cleared) would be so great as to render the tool unreliable. **Thus Article 48(1)(r) and Article 31 should be removed.** Instead we believe that CCPs should be required to raise bail-in-able long term debt that would ensure the CCP has sufficient resources to be recapitalised.

Compensation to clearing members

Above, we have stated that while certain measures such as initial margin haircutting (IMH) and resolution authority cash calls should not be utilised, and other tools like variation margin gains haircutting (VMGH) and partial tear-ups (PTUs) should only be used subject to the limitations described above. We would add that the proposed EC regulation should be enhanced to ensure that market participants (clearing members and their clients) receive compensation for any losses they suffer from the exercise of VMGH or PTU. While the draft Regulation does contemplate compensation where tools are used in deviation of CCP rules, these provisions require modification to create certainty for market participants and encourage sound governance and risk management within CCPs. This is because CCPs are not incentivised to provide for compensation as a part of its recovery rules and have uniformly structured recovery rules such that it allocates losses to clearing members and their clients and protects CCP capital.

Thus, in those extreme cases where loss allocation tools such as VMGH and PTUs are utilised, it is essential that clearing members and their clients get compensation in the form of claims for the amount lost. While these claims could be *bailed-in* (converted to equity) in the recapitalisation of the CCP as necessary, these claims should be treated as preferred (senior to) claims of the CCP and its

shareholders. We note that such compensation was contemplated in the 2014 CPMI-IOSCO recovery report and is, therefore, in line with globally agreed recommendations.

Accordingly, there are specific areas where the draft Regulation merits amendment. **We would encourage revision of Article 30 (4) which explicitly states that non-defaulting clearing members shall not have any claim against a CCP or successor entity for losses arising from VMGH.**

The draft Regulation sets out that CCPs should issue 'instruments of ownership' to non-defaulting clearing members (Article 27 (5)). This is term is overly vague and should be amended to reflect that this compensation comes in the form of senior claims as noted above. The draft Regulation sets out provisions in Article 17 (7) (l) allowing that a resolution authority can require CCPs or their group entities to issue liabilities that can be written down in resolution in order to remove impediments to resolution, but believe that this should be strongly considered as a key tool for resolution.

The same Article stipulates that this compensation should only be provided if the loss allocation is in deviation to the CCP's operating rules. AmCham EU disagrees with this provision**. In order to create appropriate incentives for sound governance and risk management, compensation should not apply exclusively to deviation from CCP rules, but to all loss allocation situations.**

Some members believe that in structuring compensation claims, it is important that incentives for clearing members to bid aggressively in the auction process are maintained, the non-recourse clearing principle remains intact and the capital structure is not altered such that clearing members become holders of equity in a CCP. These members also feel that there should be no contingent claims against the estate of the defaulter.

Other members believe that neither the prospect of retaining compensation claims nor the possibility they could be bailed in as equity of a resolved CCP would adversely affect the incentives to bid aggressively in auctions and that it is important for a resolution authority to have the flexibility to bail in compensation claims as equity (whether common or preferred) or debt (whether senior or subordinated) of the resolved CCP. These members also believe that compensation claims are inherently inconsistent with the non-recourse clearing principle (since that principle requires the extinguishment, rather than deferred payment, of liabilities of the CCP under certain circumstances), but feel that non-recourse provisions should no longer be a structural feature utilized by any CCPs.

No Creditor Worse Off Principle

All claimants to a CCP similarly-situated under the hierarchy of claims should be treated in a similar manner. The "no creditor worse off" principle states that creditors – those bondholders, shareholders or, in the case of CCPs, customers such as clearing members and their clients – who face losses from resolution, should not fare worse in the resolution than they would have, had the CCP gone into a normal insolvency situation. To this end, we disagree with the use of CCP operating rules as a counterfactual for default losses. Current recovery rules requirements ensure that CCPs allocate all

losses to members and do not provide any claims for this loss allocation such that CCP shareholders do not bear any losses beyond their skin-in-the-game contribution. This in turn would have the unintended consequence where (i) the CCP would not enter into resolution as a result of default losses or (ii) even where a CCP is resolved, the application of CCP rules as counterfactual means that any recoveries made by the CCP proceeds from sale would compensate CCP shareholders rather than the members who absorb the losses. Although the draft Regulation Recital (33) and Recital (45) and Article (32 (1) and 33 (2) rightly state that shareholders should not retain rights once the CCP has been put in resolution and that shareholders should have absorbed losses, this would be hard to achieve under the current counterfactual. **Therefore, AmCham EU feels that Article 60 should be amended to ensure that the counterfactual to loss allocation is insolvency in all cases and never application of CCP rules.**

Non-default losses

Not only are CCPs at risk from losses due to defaults of clearing participants. CCPs, like banks, electricity providers and other so-called 'critical infrastructure' are increasingly at risk from cyberattacks. There are also many other types of operational risks and other types of losses (legal, investment, custodial, general business losses etc.) that have the potential to destabilise CCPs. Furthermore, clearing participants have no control over these types of non-default losses. Only the CCP's management can effectively prevent, control and mitigate non-default losses. Therefore, these losses should ultimately remain the responsibility of the CCP's shareholders. Tools that allocate losses to clearing participants should not be utilised to address non-default losses. We feel that allowing CCPs to depend on clearing participants in non-default loss situations will only produce moral hazard within the CCP and its ownership. Ultimately, CCP capital should be sized appropriately to cover non-default losses. **AmCham EU feels that the CCP rulebook should set out clearly that CCPs and CCP ownership are responsible for non-default losses and the arrangements for dealing with non-default losses. CCP rulebooks should explicitly prohibit the use of loss allocation tools for non-default losses.**

Third country equivalence

AmCham EU supports international standards for recovery and resolution that are currently being developed by global bodies (FSB, Basel Committee, CPMI-IOSCO) and consistent application of these rules on a global level. We are pleased that the intention of EU policymakers is to continue to incorporate the global framework in the Regulation. Quite rightly in the view of AmCham EU, the European Commission does not address the issue of third-country equivalence in the Regulation. The Regulation aims to produce a recovery and resolution regime for CCPs in Europe and therefore there is no place for an equivalence assessment, just as rules that govern recovery and resolution of banks do not address this. What is needed in resolution of systemic, cross-border institution is good cooperation between authorities in multiple jurisdictions – an issue which the proposals seek to address. In our view, a main concern in the EU rules should not whether US, or other jurisdictions are equivalent, but whether EU CCPs have an effective regime in place.

Conclusion

As stated previously, AmCham EU's membership is extremely supportive of the European Commission's proposals to improve resilience, recovery and resolution of CCP. We see this as one of the final pillars needed to improve financial stability and protect the financial system as whole. While supportive, we have expressed above certain areas where we feel the rules could be enhanced to improve stability and certainty in the market as well as create the right incentives for CCPs to improve their safety. We remain at the disposal of EU co-legislators and look forward to engaging constructively as this debate continues.