EU recovery and resolution proposals for CCPs

Summary

The European Commission has published a proposal for a Regulation on a framework for the recovery and resolution of central counterparties (CCPs). This follows the work at the international level of the Financial Stability Board which has developed the “Key Attributes of Effective Resolution Regimes for Financial Institutions” (November 2011) together with related guidance (including on the resolution of non-bank financial institutions) and of the Committee on Payment and Market Infrastructures and the International Organization of Securities Commissions which have developed guidance on recovery plans for financial market infrastructures (FMIs), including CCPs.

The proposal is comparable to the EU recovery and resolution framework for banks contained in the Bank Recovery and Resolution Directive (BRRD), but adapts the recovery and resolution framework given the specific features of CCPs’ business models and the risks they face.

The proposal will be of interest to clearing members of CCPs, since it contains a loss allocation tool to be used when existing CCPs’ pre-funded loss cover (required to be held under the European Markets Infrastructure Regulation (EMIR)) is exhausted. In addition, there are a number of other provisions which will directly affect clearing members.

The text of the proposed Regulation has EEA relevance and hence will be applicable to non-EU, EEA countries once incorporated into the EEA Agreement. Whether the Regulation would apply in the UK, if the UK were to invoke Article 50 of the Lisbon Treaty, and consequently leave the EU (Brexit), depends upon the future relationship of the UK and the EU. If the UK were to remain a member of the EEA following a Brexit, the Regulation would apply to the UK once incorporated into the EEA Agreement; but in other scenarios, the UK would become a third country for the purposes of the Regulation, unless special terms are negotiated between the UK and EU.

Key business impacts

- CCPs (and in some cases groups containing CCPs) will be required to prepare detailed recovery plans. Clearing members are required to inform their clients fully how they would transmit to those clients any losses or costs arising from the exercise of recovery tools by the CCP.
- CCPs will have to redraft operating conditions to ensure compliance with the proposed Regulation, and, in particular, with the requirements to ensure recovery options may be applied to contracts or assets governed by the law of a third country or to entities based in third countries and to ensure recognition of the possibility that an EU authority may apply the loss and position allocation tools to contracts with entities based in third countries.
- CCPs will be required to address or remove any substantive impediments to resolvability (identified by the resolution authority and resolution college). In the absence of the CCP proposing measures that are considered suitable by the resolution authority, that authority

may identify “alternative measures” including limiting uncovered exposures, changes to the collection of margin, restrictions on new or existing business lines and the limiting or cessation of existing or proposed activities.

- Clearing members will be subject to the resolution authority’s powers to require clearing members to provide further cash contributions, to reduce variation margin due to a CCP (including to zero) and to enforce any existing and outstanding contractual obligations of the CCP participants. Failure to pay (i) the net amount due under closed out contracts (terminated by the resolution authority) with the CCP or (ii) under resolution cash calls, may result in the clearing member being placed into default.
- Clearing members will have to redraft their contracts with clients to whom they provide clearing services, to reflect the potential use of powers by a resolution authority which affect contracts entered into by the clearing member on a client’s behalf.

Introduction

Under the proposal CCPs are required to prepare comprehensive recovery plans that detail how they would cope with a financial distress situation where the losses exceed the available default management resources. The competent authority of the CCP is required to review the recovery plan.

The recovery plans are required to contain details of the binding arrangements between CCPs and their clearing members to act in accordance with pre-agreed operating rules in case of a resolution. Competent authorities will be able to exercise early intervention powers when a CCP is infringing or likely to infringe the prudential requirements of EMIR.

Resolution authorities are required to be designated for CCPs and to chair a resolution college for each CCP. The resolution authority is required to prepare a resolution plan for how the CCP would be restructured and the critical functions maintained in the event of the resolution of the CCP. Resolution authorities will also be able to address barriers to resolvability of the CCP following a resolvability assessment.

The resolution authority is given various wide-ranging tools and powers to address impediments to resolution and to enable the CCP to be put into resolution. The resolution tools include:

- the position management tool;
- the loss allocation tool;
- the write-down and conversion tool;
- the sale of business tool; and
- the bridge CCP tool.

In addition, the resolution authority is given all necessary powers to use the resolution tools effectively. Of particular relevance to participants in CCPs are the powers to close out contracts (requiring payment of amounts due thereunder) and to make resolution cash calls (this is discussed further below).

Each CCP will be required to prepare a recovery plan

Recovery plans

Each CCP will be required to prepare a recovery plan setting out its plans for measures to be taken to restore its financial position following any significant deterioration of this or risk of breach of its prudential requirements under EMIR. The plan should cover any form of financial distress including the default of a clearing member (default event), as well as other risks or losses arising (non-default events, such as a cyber-related breach). The plan should not assume any access to public support or funds.

Under Article 45 of EMIR a CCP is required to have a pre-defined sequence of loss absorption upon the default of a clearing member (the default waterfall). The recovery plan is required to state what will happen when the default waterfall of the CCP has been exhausted (or is likely to be exhausted) or when the CCP has breached (or is likely to breach) its capital or other regulatory requirements.

Clearing members are required to inform their clients fully how they would transmit any losses or costs arising from the exercise of recovery tools by the CCP

The CCP can determine the appropriate range of options and recovery tools that it will put in place including:

- to re-match the CCP's book by terminating contracts, thus crystallising gains and losses;
- establishing voluntary agreements (e.g. by way of auction) with the remaining clearing members so that they voluntarily take on positions;
- requiring remaining clearing members to contribute additional resources (subject to a cap); or
- haircutting payments due to clearing members as a result of a gain in a derivatives contract (variation margin haircutting).

The proposed Regulation does not specify which options should be contained in recovery plans, but it requires that the plans should "constitute arrangements agreed between CCPs and their clearing members in order to reinforce their effectiveness in all cases, binding or committing clearing members to act in accordance with pre-agreed operating rules in case they are activated regardless of the jurisdiction in which they are based". Clearing members are required to inform their clients fully how they would transmit any losses or costs arising from the exercise of recovery tools by the CCP to them.

The recovery plan is reviewed by the CCP's competent authority (or, in certain cases, the CCP's parent undertaking's competent authority) which may require the CCP to take any measures to address any material deficiencies in the plan. Given the possible impact of the plan upon clearing members, the college set up under EMIR is required to be involved in the process.

The competent authority is required to assess the plan in light of the CCP's capital structure, default waterfall, the level of complexity of the organisational structure and the risk profile of the CCP. In addition, the competent authority is required to consider the impact the implementation of the plan would have on clearing members, their clients, the financial markets served by the CCP and the financial system as a whole.

Resolution plans

The resolution authority is required, in coordination with the resolution college and in consultation with the competent authority, to draw up a resolution plan. This plan provides for the actions that the resolution authority may take where the CCP meets the conditions for resolution. The resolution plan is required to take into account relevant scenarios, including that the CCP's failure may occur in a time of broader financial instability or system wide events. In drawing up the plan, the resolution authority takes into account the impact of the plan on clearing members and clients, any linked CCP, financial markets, trade repositories and the financial system as a whole. The plan should include an analysis of how and when a CCP may apply for the use of central bank facilities and identify assets that can be used as collateral for this purpose. Resolution plans are reviewed and will need to be updated at least annually.

Resolvability assessment

The resolution authority, in cooperation with the resolution college, will be required to assess the extent to which the CCP is resolvable, without assuming any extraordinary public support or any central bank liquidity assistance (provided either on an emergency basis or under non-standard collateralisation, tenor and interest rate terms).

If the resolution authority and resolution college conclude that there are substantive impediments to the resolvability of a CCP, the resolution authority (in cooperation with the competent authority) will send the CCP and the resolution authority a report. The CCP will then have four months to propose possible measures to address or remove the substantive impediments identified. If the measures proposed by the CCP would not, in the view of the resolution authority and resolution college, reduce or remove the impediments, the resolution authority will identify alternative measures. The measures available to resolution authorities are fairly extensive and include:

- requiring the CCP to limit its maximum individual and aggregate uncovered exposures;
- requiring the CCP to make changes to the composition and number of its default funds;
- requiring the CCP to make changes to how it collects and holds margin;

- requiring the CCP to limit or cease specific existing or proposed activities; and
- restricting or preventing the development of new or existing business lines or provision of new or existing services.

Conditions for resolution and resolution objectives

Similar to the BRRD, the proposal sets out the conditions which must be met before a CCP can be put into resolution by a resolution authority. These conditions are:

- broadly, that the CCP is failing or is likely to fail, as determined by either the competent authority or the resolution authority;
- there is no reasonable prospect that any alternative measures would prevent the failure of the CCP within a reasonable timeframe; and
- a resolution action is necessary in the public interest.

When exercising the resolution tools, the resolution authorities must have regard to the resolution objectives and must balance them as appropriate. The resolution objectives are, essentially:

- to ensure the continuity of the CCP's critical functions including the timely settlement of the CCP's obligations to its clearing members and access of clearing members to securities or cash accounts and collateral with the CCP;
- to ensure the continuity of the links with other FMIs;
- to avoid a significant adverse effect on the financial system;
- to protect public funds by minimising reliance on extraordinary public financial support; and
- to minimise the cost of resolution on all affected stakeholders and avoid destruction of the CCP's value.

Resolution tools and powers

The proposed Regulation sets out a number of resolution tools which resolution authorities could use to resolve a CCP:

- the position and loss allocation tools;
- the write-down and conversion tool;
- the sale of business tool;
- the bridge CCP tool; and
- any other resolution tool consistent with the resolution objectives and principles in the proposed Regulation (although this could result in differences between national resolution regimes).

A resolution authority is required to have all powers necessary to use the resolution tools effectively

In support of the resolution tools, a resolution authority is required to have all powers necessary to use the resolution tools effectively. Of particular relevance to participants in CCPs (where participant means clearing members and clients), these powers include:

- the power to reduce (including to zero) the amount of variation margin due to a clearing participant of a CCP under resolution;
- the power to enforce any existing and outstanding contractual obligations of the participants of a CCP under resolution; and
- the power to require clearing members to provide further contributions in cash.

It is worth noting that prior to the use of the resolution tools set out above, the proposed Regulation requires the resolution authority to enforce:

- any existing and outstanding rights of the CCP, including any contractual obligations by clearing members to meet cash calls, to provide additional resources to the CCP, or to take on positions of defaulting clearing members, whether through an auction or other agreed means in the CCP's operating rules; and

- any existing and outstanding contractual obligation committing parties other than clearing members to any forms of financial support.

It is possible for the resolution authority to refrain from this requirement (either partially or in full), but only to avoid significant adverse effects on the financial system, or widespread contagion, or where the use of the resolution tools is more appropriate to achieve the resolution objectives in a timely manner.

Position and loss allocation tools

Whilst a number of the resolution tools are similar to those in the BRRD (the sale of business tool and the transfer to a bridge institution for example), the position and loss allocation resolution tools are specific to CCPs. The tools can be used in respect of all contracts relating to clearing services and the collateral related to those services posted to the CCP.

- The position management tool is used to rematch the book of the CCP or bridge CCP. The resolution authority can terminate certain or all of the contracts of the clearing member in default, the contracts of the affected clearing service or asset class or the contracts of the CCP in resolution. Prior to terminating any of the contracts, the resolution authority must require the CCP to value each contract and update the account balances of each clearing member, determine the net amount payable by, or to, the clearing member and notify and collect the amounts due. If a non-defaulting clearing member is unable to pay the net amount, the resolution authority may require the CCP to place the non-defaulting member into default and use its initial margin and default fund contribution in accordance with EMIR.
- The loss allocation tool can be used for a number of purposes, including to cover the losses of the CCP, to restore the ability of the CCP to meet payment obligations and to recapitalise the CCP and replenish its pre-funded financial resources to an extent sufficient to restore its ability to comply with the conditions for authorisation and to continue to carry out its critical functions. As part of this tool, the resolution authority can reduce the value of any gains payable by the CCP to non-defaulting clearing members and issue a resolution cash call (that is, requiring 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). If a non-defaulting clearing member does not pay the required amount, the resolution authority may require the CCP to place that clearing member in default and use the clearing member's initial margin and default fund contribution in accordance with EMIR.

These tools could have a significant impact on non-defaulting clearing members

Clearly these tools could have a significant impact on non-defaulting clearing members, especially where they are unable to pay the CCP.

However, the *quid pro quo* is that the CCP will have to issue instruments of ownership to all non-defaulting clearing members affected by the loss and position allocation tools (in deviation from the CCP's operating rules) which resulted in the clearing member suffering a financial loss. The number of instruments of ownership issued to each affected non-defaulting clearing member must be proportionate to its loss and must take account of any outstanding contractual obligations of the clearing members toward the CCP.

Write down and conversion tool

The write down and conversion tool is similar to the "bail in" tool contained in the BRRD. The resolution authority can use the tool in respect of instruments of ownership and debt instruments or other unsecured liabilities in order to absorb losses, recapitalise the CCP or a bridge CCP, or to support the use of the sale of business tool.

In addition, the tool can be used by the resolution authority in respect of instruments of ownership and debt instruments issued by the parent of the CCP in resolution where the instruments of ownership are used to fulfil the CCP's capital requirements under EMIR or those instruments of ownership or debt instruments are issued for the purpose of funding the CCP and they fully absorb losses or constitute subordinate claims in normal insolvency proceedings.

The resolution authority is required to use the tool in accordance with the priority of claims that applies under normal insolvency proceedings. Before reducing or converting the principal amount of debt instruments or other unsecured liabilities, the resolution authority must reduce the notional amount of instruments of ownership in proportion to the losses and up to their full value, where necessary.

The following liabilities cannot be bailed in:

- certain liabilities to employees;
- liabilities to commercial or trade creditors arising from the provision to the CCP of goods or services that are critical to the daily functioning of its operations, for example, IT services;
- liabilities to tax and social security authorities, provided that those liabilities are preferred liabilities under the applicable insolvency law;
- liabilities owed to systems or operators of systems designated according to the EU Settlement Finality Directive.

Article 33 of the proposed Regulation includes the comment that resolution authorities are not prevented from applying a "write-up" mechanism, to reimburse holders of debt instruments or other unsecured liabilities (and then holders of instruments of ownership) where the level of write-down based on the provisional valuation is found to exceed required amounts.

Sale of business tool

The resolution authority can exercise its powers to transfer instruments of ownership of a CCP

The resolution authority can exercise its powers to transfer instruments of ownership of a CCP, or any of its assets, rights, obligations or liabilities, to a third party purchaser. The transfer must be made on commercial terms (having regard to the circumstances) and must take into account the state aid framework.

The consideration paid by the purchaser will benefit:

- the owners of the instruments of ownership where the sale of business has been effected by transferring instruments of ownership issued by the CCP from the holders of those instruments to the purchaser;
- the CCP, where the sale of business has been effected by transferring some or all of the assets or liabilities of the CCP to the purchaser; and
- any non-defaulting clearing members that have suffered losses prior to resolution.

The allocation of any consideration paid by the purchaser shall be carried out in accordance with the CCP's default waterfall as set out in EMIR and the priority of claims under normal insolvency proceedings.

Bridge CCP tool

The resolution authority is able to transfer instruments of ownership of a CCP, or any of the CCP's assets, rights, obligations or liabilities, to a "bridge CCP". The bridge CCP must be a legal person which is controlled by the resolution authority and is wholly or partially owned by one or more public authorities, and it must have been created for the purposes of being a bridge CCP.

Similar to the sale of business tool, the consideration paid by the purchaser (unless provided elsewhere in the proposed Regulation) will benefit:

- the owners of the instruments of ownership where the transfer to a bridge CCP has been effected by transferring instruments of ownership issued by the CCP from the holders of those instruments to the bridge CCP; or
- the CCP under resolution, where the transfer to a bridge CCP has been effected by transferring some or all of the assets or liabilities of the CCP to the bridge CCP.

Third countries

Under the proposed Regulation, a CCP is required to ensure that the actions in its recovery plans are binding across all relevant jurisdictions. The recitals (24 and 61) require the CCP's operating rules to include (i) contractual provisions to ensure recovery options may be applicable to contracts or assets governed by the law of a third country or to entities based in third countries and (ii) the recognition of the possibility that an EU authority may apply the loss and position allocation tools to contracts with entities based in third countries.

As part of the assessment of resolvability carried out by the resolution authority, the CCP may be asked to demonstrate that the contracts of the CCP with clearing members or third parties

The CCP may be asked to demonstrate that the contracts of the CCP with clearing members or third parties do not enable those parties to challenge the exercise of resolution powers by a resolution authority

do not enable those parties to challenge the exercise of resolution powers by a resolution authority or otherwise avoid being subject to those powers.

The proposed Regulation recognises that effective resolution of internationally active CCPs will require co-operation between EU and third country authorities, potentially including the UK after a Brexit. ESMA is tasked with providing guidance on the content of co-operation arrangements with third country authorities.

In addition, relevant national authorities are charged with recognising or giving effect to actions by third country resolution authorities on relevant clearing members, contracts, assets or liabilities located in the EU. Recognition should occur provided (i) the measures do not have an adverse effect on the financial stability of the member state, (ii) CCP creditors receive the same treatment as other creditors regardless of location and (iii) there are no material fiscal implications for the member state.

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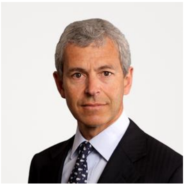

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