Recovery and Resolution for CCPs

Overview of document
Nasdaq OMX Clearing AB ("Nasdaq Clearing", “the CCP”) is authorised under EMIR and also complies with other global standards such as the CPMI-IOSCO Principles for Financial Market Infrastructure. Nasdaq Clearing has paid close attention to recent publications on recovery and resolution by CPMI-IOSCO\(^1\); FSB\(^2\); the European Commission\(^3\) and ISDA\(^4\), as well as other industry commentary. The CCP is supportive of the EACH paper “An Effective Recovery and Resolution Regime for CCP’s\(^5\). This document is intended to give an overview of the opinion of Nasdaq Clearing.

Summary of Nasdaq Clearing’s views
1. A recovery regime should focus on the tools that CCPs can draw from above and beyond those required by EMIR.
2. The resolution of a CCP should be led by the resolution authority of the jurisdiction where the CCP is established.
3. Access to central bank liquidity should be extended to all CCPs to reduce systemic risk.
4. Any changes or additions that affect CCPs should be carefully considered so as not to have a negative effect of the existing ability of a CCP to deal with a default situation.
5. The existing CCP risk framework incentivises appropriate risk taking.

A CCP is not a bank
Tools that work for a bank will not necessarily work for CCPs. The sole purpose of a CCP is to manage risk – it is not to take positions, or benefit from taking risks. In fact the mechanisms in place such as risk models, defaults funds, financial waterfalls, membership requirements, concentration limits etc. are all intended to reduce the risks of the market. On the other hand a bank makes money by taking risk. Banks have various businesses related to risk taking: investing on own account, investing on the account of its clients, securitisation, provision of loans etc.

The initial margin that CCPs calculate and call from members are roughly equivalent to the risk calculations and reserves held by banks. However, CCPs have default waterfalls on top of this initial margin. Therefore CCPs are already extremely well prepared to deal with recovery situations.

However, although CCPs do not take risk they can be exposed to a liquidity risk when there is a time delay in payments. CCPs that do not have access to short term liquidity from their central bank are exposed to this time delay more than those that have central bank liquidity. Such access to central bank liquidity is a fundamental tool to prevent and minimize the risk that a CCP would enter into a recovery situation.

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\(^3\) Discussion Paper on CCP recovery and resolution 2nd ad hoc meeting with Member States
\(^4\) ISDA: http://www2.isda.org/functional-areas/risk-management/
The CCP framework incentivises appropriate risk taking

The risk management framework of a CCP consists of several layers of defence such as membership requirement, margin requirement, eligible collateral, financial resources and default management. The infrastructure of the loss distribution process in a CCP is designed to align risk between the CCP and its members and by that incentivise appropriate risk taking.

- Before the financial waterfall is touched, in a default situation the first lines of defence are the variation margin and the initial margin of the defaulting member. These are calculated based on strict requirements in EMIR and incentivise the members to manage their own risks.
- The next layer is the CCP ‘skin in the game’ funded by the CCP itself – calculated as 25% of the CCP’s regulatory capital requirement. This incentivises the CCP to manage risks correctly.
- After this is the mutualised default fund – these are funds where all members contribute based on their exposures, however if the initial margin and skin in the game are used all members will be liable for these losses. This structure incentivises all members to support the CCP in re-balancing the books.

The risk framework of a CCP is proven in real scenarios with successful results, i.e., it works. The bankruptcy of Lehman’s only used 35% of the initial margin, and no other lines of the default waterfall were required, thus showing that the appropriate incentives have been set.

Nasdaq Clearing does not wish to see Recovery or Resolution proposals which would alter these incentives as this could risk changing the behaviour among participants in case of a default scenario.

Nasdaq Clearing’s view on proposed Recovery Tools

Once the default waterfall has been exhausted Nasdaq Clearing believes the following recovery tools could be considered by a CCP. However the possible exposure on members should be pre-defined in the CCP rulebook, and exposure should be limited.

1. **Assessment power** - Additional contributions from participants – Nasdaq Clearing support this, and it is already available to Nasdaq Clearing via its rulebook.

2. **Variation Margin (VM) haircutting / Profit Cropping** - Reduction in the net VM gains / profits due to the non-defaulting members. Nasdaq Clearing supports this proposal as an option once the default waterfall has been depleted.

3. **Loss distribution** - Sharing the defaulter’s VM losses across the non-defaulting clearing members (as opposed to only those with positive VM). Nasdaq Clearing can support this proposal as an option once the default waterfall has been depleted. However, the benefit would be limited in value.

4. **Allocation of positions** - The CCP closes member positions in a specific asset class/market segment at prices it can make. This should be done pro-rata, effectively, shrinking a members’ exposure to the asset class/market segment of the market where there is a loss that the CCP cannot cover with its resources. Nasdaq Clearing can support this proposal as an option once the default waterfall has been depleted. However, the benefit would be limited in value.

5. **Temporary or Permanent closure of one particular clearing service** - The CCP legally closes all contracts early, at price X. Nasdaq Clearing does not believe in this tool. To “tear up” contracts in an extreme market scenario will impose a lot of risk to the non-defaulting participants (i.e. the ones that should help re-capitalizing the CCP), which could lead to further defaults and escalation of the situation. Also, in a default of a larger GCM,
the Member will be active in multiple markets and service closure in such scenario will lead to large systemic risks.

6.- Insurance – In losses from a non-default event Nasdaq Clearing can see the benefit of a form of insurance. However in a default event the likelihood of the insurance industry being able to pay out quickly enough is questionable. If insurance was mandated then the cost of the insurance would be high and the availability low.

Recovery tools to cover Operational or Treasury losses
The size of losses from operational or treasury failures would be significantly less than a default. Under EMIR, CCPs are required to hold sufficient capital to conduct an orderly wind down as required by the Principles for Financial Market Infrastructures (PFMIs). They are also required to hold capital for credit, counterparty, market, operational, legal and business risks.

Recovery tools to cover liquidity shortfalls
Nasdaq Clearing must comply with strict liquidity requirements under EMIR. However, Nasdaq Clearing does not have access to short term overnight liquidity from its central bank (which is available to some CCPs in some countries). Nasdaq Clearing believes that to increase financial stability this access should be extended to all CCPs that meet robust standards and include overnight liquidity in the major currencies cleared by the CCPs. It is also of importance that the access to overnight liquidity is not restricted to CCPs with residence in the jurisdiction of the applicable currency.

Nasdaq Clearing’s view on proposed Resolution Tools
Nasdaq Clearing believes CCPs should only be put into resolution once the CCP’s recovery process is exhausted or it is deemed by the regulators to be insufficient.

Sale of business – This may be practical if the failure of the CCP is due to non-default losses, and the CCP is only in need of more capital. In a default situation, it would be hard to sell the business without further negative impact on the market.

Compensation – Nasdaq Clearing does not support compensation of losses, unless the CCP makes a profit from the default management process – in that case affected members could get back the part of the profit that is attributable to them. (For example through a successful variation margin haircutting process).

Bail-in of new unsecured debt and write-down of equity e.g. by writing down and/or converting outstanding debt into equity. CCP’s generally do not issue bonds or other forms of unsecured debt. Nasdaq Clearing believes that issuing debt makes the CCP a leveraged institution, which is not something that a CCP wants. Aside from that, issuing debt means that the CCP is underwriting a higher proportion of the risk – something which Nasdaq Clearing is strongly against for the reason of incentivising risk taking. In addition, buyers of the bonds become exposed to the CCP – if they are members already then their exposure increases, if they are not members then this is spreading the default risk to other parts of the market. Any issuance of debt must be regarded as a type of hybrid debt security and be eligible (fully or partly) as equity in regulatory capital calculations.

Alternative pre-funded loss absorbency and recapitalisation resources (Total Loss Absorbency Capacity, TLAC). A pre-funded pool above the default waterfall will add a significant additional cost of clearing to the industry. G20 recommendations and ensuing regulations such as EMIR were intended to move the market towards clearing. Additions such as TLAC could tip that balance back to OTC, non-cleared transactions. In addition, how much is enough for the additional fund? No amount is guaranteed to be enough.
**Initial Margin Haircutting** – Nasdaq Clearing believes that initial margin haircutting should not be used as a recovery or resolution tool. Initial margin is intended to manage the exposures of the risk taker and should not be mutualised. In an extreme market scenario IM haircutting will lead to collateral deficits that not all Members will be able to manage and hence pushing more participants into default.

**Conclusion**
Nasdaq Clearing is supportive of the concept of Recovery and Resolution, but urges authorities to be mindful of existing regulations that already ensure CCP’s manage and cover their risks adequately, and also the risk that making changes could have a negative effect in a default situation rather than a positive effect.

The overall objective of recovery and resolution tools should be to focus on securing the survival of the CCP in some form a going concern for the CCP as this will be the best outcome from a market stability perspective in an extreme market situation.

We strongly support that the resolution authority is an entity in the jurisdiction where the CCP is established. A college of resolution authorities would only sub optimize the decision process in a situation where quick and firm decision is a pre-requisite for a successful recovery and resolution process.