SESSION SUMMARY - BERLIN SEPTEMBER 2020

How to address key CCP outstanding issues?

1. Lessons from the Covid crisis: strengths and weaknesses of EU CCPs

A regulator suggested that the March-April Covid crisis was a real-life stress test of the resilience of CCPs. CCPs showed resilience, complying with regulation throughout the crisis, and also played their role as shock absorbers. However two questions can be raised. One is about how margin calls fluctuated during the crisis and whether the anti-procyclicality measures (APC) mandated by EMIR[1] for handling the inherent procyclicality of margin calls, especially variation margins (VM) and intra-day margin calls, were effective. A second question concerns the capacity of CCPs to manage the clearing process and possible events such as defaults in the specific stress situation of the lockdown.

1.1 Margin models and anti-procyclicality measures

Two speakers, representing major CCPs, considered that their margin models and the EMIR anti-procyclicality measures worked as designed during the first phases of the Covid crisis.

An industry representative explained the concepts of Variation and Initial Margins (VM and IM). VM represents the marking-to-market of losses or gains in any asset class. With participants providing VM daily through the CCP, there is a mechanism that prevents the build-up of credit exposures and undue systemic risks, which was an objective put forward following the 2008 financial crisis in order to make financial markets safer. The IM is there to cover future market moves and to allow the CCP to be in a position to withstand even dramatic shocks to the markets, such as the Covid crisis. The size of margin swings is specific to each asset class. In addition, models make margin fluctuations quite predictable, depending on the magnitude of anticipated market swings. Market participants can thus anticipate the amounts of cash that will be needed in a transparent way, without 'draining liquidity' from the market. The speaker felt that, from a CCP perspective, the scenarios anticipated and used as the basis to determine the need for and size of VM and IM had worked well in cleared markets during the Covid crisis and the anti-procyclicality measures built-in proved to be adequate.

A second industry representative explained that during the Covid crisis, their institution, a major CCP, experienced a single-digit increase in margins. This is probably because they use conservative risk policies (including risk models and EMIR anti-procyclicality measures), above EMIR standards. These risk policies had been tested during fire drills and worked well throughout the crisis. This shows that CCPs have helped the market to better approach and face these difficult circumstances, the speaker considered. VM helped to cover market volatility and movements and contributed to protect the CCP membership from the effects of the market stress, by making sure that there was no sudden need for increasing margins.

A third industry representative pointed out issues with the number of breaches seen during March and April, and the subsequent size of margin increases. For the whole of 2019, there were 40 margin breaches across the contracts tracked. For just 9 March 2020 there were more than 250 margin breaches. What was concerning also was that the increases in margin were larger than in 2008, showing the unprecedented volatility that the market faced. Potential lessons can be learned from comparing the performance of margin models across different asset classes, and at different clearing houses, because the margin models differ in the way they are constructed. One way is through the margin period of risk, which is significantly longer for OTC contracts than for futures and other exchange-traded derivative (ETD) products. OTC contracts saw less significant margin increases than the ETD, which is something that needs to be further assessed. In addition, an evaluation of how the three possible anti-procyclicality EMIR measures that can be used by CCPs performed during the crisis would also be useful. Europe has been at the forefront of these measures and there may be room for further refinement in order to avoid excessive margin increases that may add stress to the system.

The first industry speaker stated that there has to be caution when comparing cleared and uncleared markets. Margin models are more stable in the uncleared space because they are only reviewed once a year. But without marking-to-market, potential exposures are not precisely evaluated. Much better disclosure would be needed in the uncleared space for such comparisons to be valid.

The regulators on the panel also considered that the margin system and anti-procyclicality measures of EMIR generally worked during the Covid crisis.

An official identified some possible unintended consequences of these measures. To have less steep increases in margining at times of stress, there will have to be more margining in normal times. Secondly, it was observed that intra-day margin calls were quite substantial late in the day certain days. At that time, the chances are that the payment will have to be made in US dollars, which raises two issues. Clearing members have to source the dollars and secondly, this may create a problem for the CCP in terms of what to do with the dollars received

[1] Procyclicality of margin refers to the fact that margin requirements for the same portfolio are higher in times of market stress and lower in calm conditions. The anti-procyclicality margin measures under EMIR seek to establish consistent, efficient and effective supervisory practices and to ensure a common, uniform and consistent application of EMIR in order to limit procyclicality of CCP margins. The adoption of the guidelines should enable national competent authorities (NCAs) to better supervise their CCPs in this respect. CCPs may also need to adapt their models and processes to the guidelines. CCPs are required to monitor and account for procyclical effects of margins including to make disclosures on its risk management practices such as the models used for the calculation of margins. These guidelines promote consistent supervision of such requirements including: monitoring of the procyclicality of margin requirements; implementation of anti-procyclicality margin measures; and disclosures to facilitate margin predictability.

quite late in the US day. There should be a discussion with the US Fed about how this situation may be handled, the official suggested. The US authorities may however not be willing to open their accounts to allow an EU CCP to park extra liquidity overnight.

A regulator stated that the CCP system was designed from the beginning to be safe and to cover the positions. The proportion between the IM and the VM can be analysed, but it should not be assumed that, since there were huge costs to be borne to make it workable, the system has to be changed altogether. The issue of procyclicality will always be present.

Another regulator noted that VM calls reflected the volatility of the market, from one day to the next. The margin calls were met, despite significant increases and IM increased moderately. Some models experienced breaches but this was not unexpected given the market volatility. The default fund contributions in place would have been enough to cover these market moves, should a default have occurred. Only in one instance did an EU CCP have to increase its default fund size. The shocks experienced during the period showed that the scenarios used in the EU-wide CCP stress test exercise were quite plausible.

1.2 Resilience of EU CCPs during the Covid crisis

Several panellists emphasized the successful way in which the Covid crisis had been handled by EU CCPs and market participants, which demonstrated the essential role played by CCPs in ensuring market resilience. The fact that this was new territory and that potential issues had had to be anticipated in a work-from-home environment was noted. This constituted a test of business continuity arrangements for the staff of CCPs and clearing members. An industry representative also stressed that clearing remained resilient despite unprecedented volumes and volatility and that the authorities had stepped in very quickly, with liquidity and monetary stimulus. A regulator also pointed out that EU CCPs did not face any defaults. There was one default in the US and one in a non-CCP clearing house in the EU, but both were successfully managed.

Two speakers however stressed that there should be no complacency, because the Covid crisis was just one scenario and a rather specific one: it was a public health and not a financial crisis. Work has to continue on enhancing CCP resilience and anticipating different recovery and resolution scenarios.

Such real-life stress tests are a good opportunity to identify potential areas of improvement, an industry speaker suggested. On the operational side, there were consecutive days during which volumes were three times the usual daily averages. That created challenges for certain operational processes that are performed manually and where it is difficult to scale capacity up quickly. The industry is considering ways to address this issue by streamlining and automating some of those processes in order to make the system more resilient.

2. EU CCP Recovery and Resolution (CCP R&R) framework: possible areas of improvement

A regulator emphasized that the new EU CCP recovery and resolution regulation recently adopted raises two questions. First is the relevance of the regulation for handling potential systemic risks. Paul Tucker and the Systemic Risk Council (SRC) indeed recently criticized the global CCP resolution guidance proposed by the FSB with which the EU regime is consistent, due to the fact that it neither prescribes the full elimination of owner's equity before entering into resolution, nor the issuance of bail-in bonds in the way required for banks. A second question is the extent to which the EU framework reinforces or weakens EU CCPs in the global competition.

An industry representative believed that although the EU CCP R&R regulation was significantly improved compared to the first drafts, it does not go as far as desired. Some elements of the SRC response need to be considered, in particular those mentioned by the previous speaker regarding the treatment of equity and bail-in debt, which both relate to incentive alignment. It would be a strange outcome for a CCP to go through resolution to essentially fail and yet equity has a no-creditor-worse-off claim against the Resolution Authority. That does not exist in other financial resolution frameworks. Regarding bail-in debt, there is also a potential upside in terms of the CCP putting up resources ex ante to deal with losses that could crystallise during a resolution, thus facilitating the recapitalisation of the CCP and its continuity.

There are also a number of areas where further enhancements to the framework could be made, the industry speaker felt. A first area is non-default losses which should normally be covered by the CCP, since it is the CCP management that is responsible for managing the risks that may lead to such losses. A second area of improvement is increasing skin the game commitments. The industry representative's institution, a major clearing member, is satisfied that the EU regulation includes a second layer of skin in the game, i.e. a requirement that CCPs commit a second tranche of their own capital to absorb potential losses in the event of a default[2], considering that it should be fixed 'towards the higher end of the scale'. This demonstrates Europe's thought leadership role globally in this area, given that many regulators do not even require a first layer of skin in the game. This mechanism should be considered more as an incentive alignment than a loss absorption tool, the speaker added. A BIS report from earlier in 2020 analysed the levels of skin in the game at CCPs and then looked at the robustness of IM models at those CCPs. A positive correlation was found between the two, i.e. the more skin in the game there is, the more robust those IM models are. Engagement with ESMA on this question at Level 2 is anticipated positively. Cash calls are a third issue that merits consideration. For recovery and resolution tools to actually achieve their goal they need to be reliable and non-procyclical. This is recognised to a certain extent in the regulation by putting a cap on the number of resolution cash calls that can be made. It is a two times cap, and to go beyond even a one-time cap the regulation indicates that the Resolution Authority should assess the potential impact on financial stability, which seems relevant. However, there are other areas of the recovery and resolution toolkit which could potentially be procyclical and are not capped or limited, such as recovery cash calls and VM gains haircutting. Limitations similar to those for resolution cash calls should be put in place in these other areas.

[2] At present CCPs contribute a single tranche of capital that would usually be tapped once the defaulter's initial margin and default fund contributions are depleted. Instead, the second layer of so-called skin-in-the-game would sit near the bottom of the waterfall, after the various clearing member resources are exhausted but before any recovery tools like variation margin gains haircutting can be used. (Source ISDA July 2020).

An official doubted that 'wiping out the equity' or 'issuing bail-in liabilities' would really improve resolution. The official also felt that the European solution for non-default losses needs to be improved, because it would mean that an additional cash call is being brought in on the clearing members. This may distort the incentives, because non-default-related losses are the responsibility of the CCP and clearing members should not be affected by them.

An industry representative considered that the EU CCP R&R framework is generally appropriate and balanced. Increasing the capping of certain commitments does not seem necessary. Going back to the SRC comments, the speaker felt that incentives are important, and that it is key to not introduce anything in the waterfall that may reduce the appetite of participants to come in early and to help in the recovery phase. Having a 'carrot' for example at the end of the waterfall by which participants may ultimately have equity compensation and become the owners of the CCP does not seem appropriate, because it may distort the incentives.

3. Implementation of EMIR 2.2 and temporary Brexit measures

3.1 Implementation of EMIR 2.2 delegated acts and recognition of UK CCPs

A regulator stressed that the end of 2020 would be a pivotal moment for CCPs in Europe with the implementation of new EU regulations and temporary equivalence measures due to be put in place for UK-based CCPs.

A second regulator explained that EMIR 2.2 has applied since the beginning of 2020 and was prepared the previous year. The Delegated Acts were adopted by the Commission in July and are now in the non-objection period with the Council and the Parliament, so the framework should be available soon. EMIR 2.2. includes some organisational and governance changes that are currently being prepared. A CCP Supervisory Committee will notably be introduced, which will lead the work on CCPs going forward. Regarding third-country CCPs, EMIR 2.2 introduces a significant change with a tiering system based on the systemic relevance of these CCPs for the EU and a specific supervisory regime for each type of third-country CCP. This includes a new comparable compliance framework for third-country CCPs, as well as supervisory fees. The regulator noted that UK CCPs will be the first use case for these new EMIR 2.2 measures. The Commission has indicated that it plans to take an equivalence decision regarding UK CCPs. There have been preparations with the relevant authorities for the recognition process to be conducted in order to allow continued access following such a decision, taking into account the new EMIR 2.2 provisions. As soon as the decision of the Commission has been taken, which should be a matter of weeks, the process will be put in place.

A third regulator noted that when the equivalence system is complete it will have a little more flexibility, but perhaps not all the flexibility sought. The other task that will be given to ESMA together with those related to third-country equivalence, is ensuring comparable compliance, which will be important in the future system because it will ensure that in day-to-day practical life, a CCP stays in line with EMIR requirements.

An industry representative explained that a programme has been put in place over the last 3 years to allow participants using the existing venues in the UK to split their books between UK and EU-based venues. The profits made are shared between the CCP and the market participants involved in the programme. Close to 20% of the euro Interest Rate Swap (IRS) market in notional outstanding (out of a total of about €100 trillion) is now cleared in this alternative liquidity pool in the EU, which is deepening. Three years ago 99% of that amount was in London. A level playing field is however needed between EU and UK based CCPs for competition to develop on equal terms, which means granting equivalence only if regulations, including recovery and resolution frameworks, are equivalent. Another market participant agreed that this move is market-driven and may potentially benefit those who are participating.

Another industry representative stated that the clearing service operated in the UK includes 26 currencies and as of today represents about 90% of the flows around the world, providing customers with a great deal of efficiency. There was no particular pressure from customers to change the current system, but now the decision has been made, clarity is needed regarding the equivalence process and the timing of implementation of EMIR 2.2 because designing a different process has a cost.

3.2 Temporary equivalence measures in the context of Brexit

A regulator mentioned that what is on the table in the short term for UK-based CCPs is temporary equivalence. To some extent temporary equivalence could be considered to be at odds with the principle of equivalence and the new tiering framework, since an equivalence decision can normally be removed, but an official felt that this was why the Commission has insisted on the temporary nature of this recognition, which is meant to be a political signal.

The official added that with the concept of equivalence the UK in effect is tying its fate even more strongly to the EU than at present in this area. Indeed, the very moment UK CCP regulation starts to deviate, the EU will have to re-assess whether the preconditions for granting equivalence are still in place. The official added that given the dominant position of the UK for euro clearing, a direct supervision of the UK-based CCPs concerned, not only by the Bank of England but also by ESMA seems to be the right solution. However, this is a solution only as long as UK rules remain consistent with EU ones. There is a risk that the UK decides to go in another direction in the future and therefore that euro clearing business may be required to relocate to the EU. This risk needs to be mitigated by clearing members by allocating part of their euro clearing to CCPs based on the continent.

An industry representative stated that regarding equivalence and recognition, there is a need for a balanced approach and for predictability and transparency, so that market participants can prepare for the possible outcomes. As regards Brexit, the sooner there is full certainty about the equivalence and recognition of UK CCPs, the better for market participants, clearing members and CCPs. Concerning the risk that equivalence may be withdrawn at any time for UK-based CCPs, the larger global clearing firms are prepared for that possibility and have connections to a large number of CCPs that allow them to provide clients with access to the venues they need for clearing. ■