

14 January 2010

Reducing Risks Among Interoperating CCPs



Overview

1. Objectives of the discussion paper from EuroCCP,
Reducing Risks Among Interoperating CCPs
2. Market context
3. Recommendations



Objectives of the paper

- To contribute to an industry-wide discussion and resolution of concerns about the risks of multi-CCP interoperability
- To offer some fresh ideas that can help move CCPs and regulators to a consensus on important risk management issues
- To make interoperability safer and easier, for equity markets throughout Europe

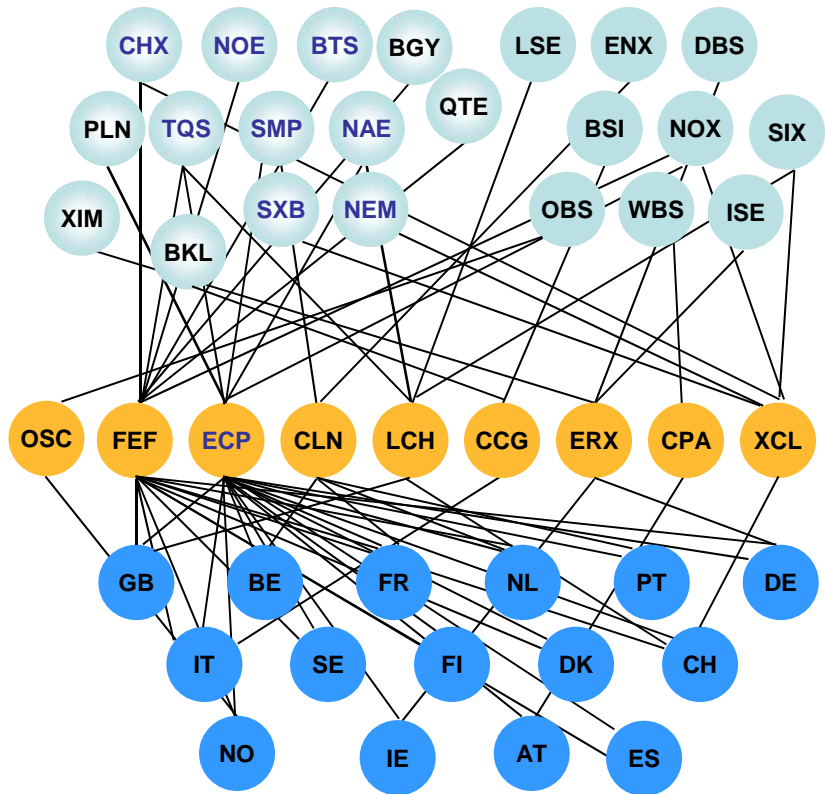


The market structure today

Competitive Trading

Fragmented Clearing

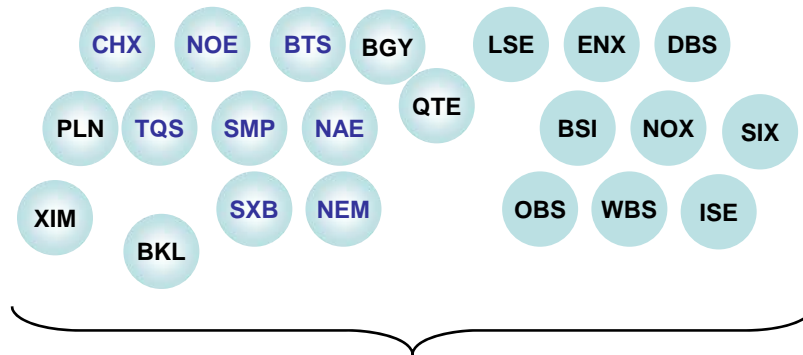
National Settlement





The market structure “tomorrow”

Competitive trading continues



via full interoperability:

CCP of a Firm's Choice



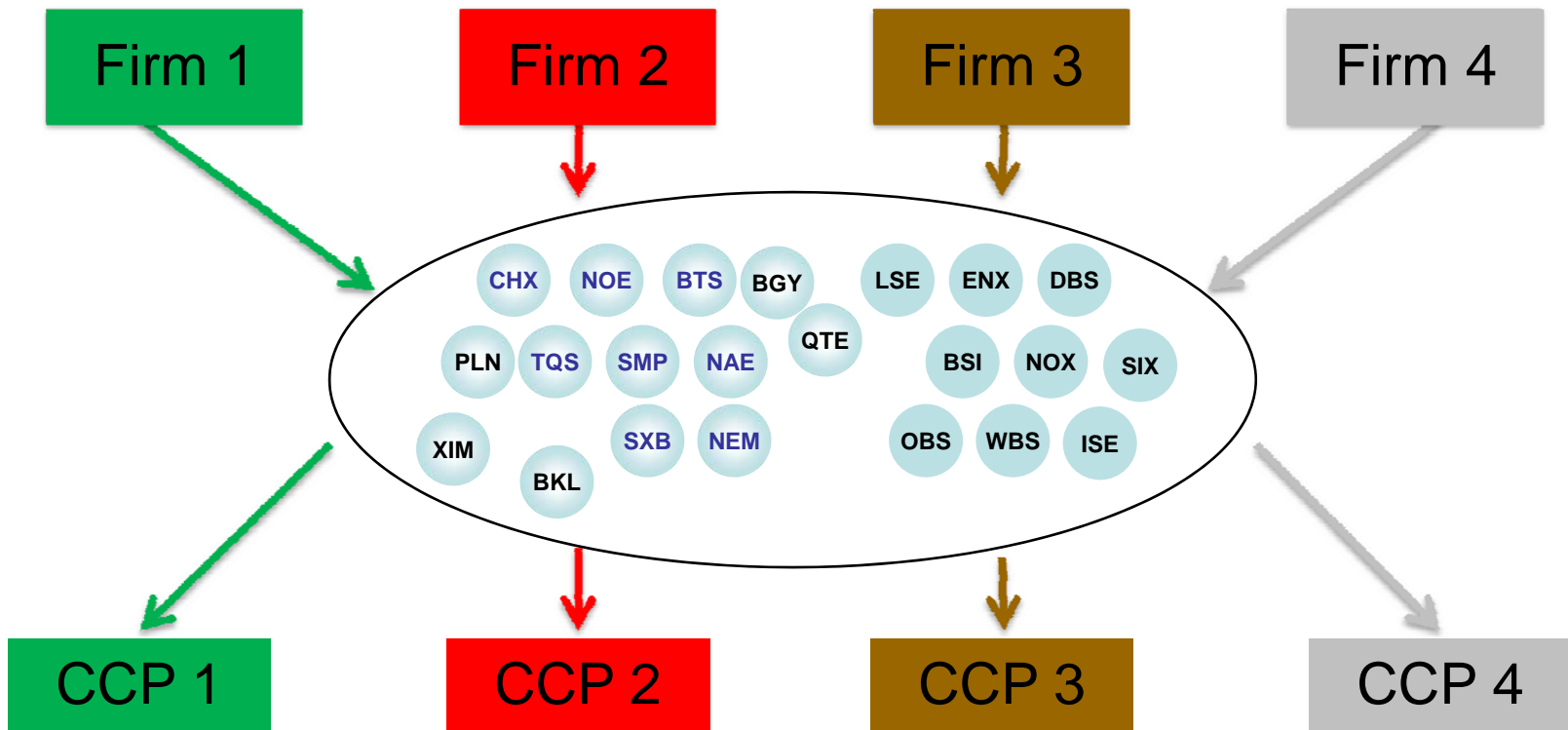
via TARGET2 Securities:

CSD of a Firm's Choice



Full interoperability delivers real choice

Trades on any venue cleared by the CCP of a firm's own choice





Interoperability requires investment

Costs

Venues: multiple supplier set up, maintenance

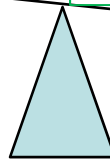
CCPs: increased risks, more obligations to settle, possible loss of market share

Market participants: pay directly or indirectly

Benefits

Venues & CCPs: Possible gains in market share
Cheaper and safer clearing spurs market growth

Market participants: lower prices, better service
Choice of CCP that best fits a firm's business model
Less connectivity, margin and default fund costs





Achieving full interoperability

EuroCCP recommendations to make multi-CCP interoperability safer and easier:

1. Augmented default fund
2. Interoperability convention
3. Remove commercial barriers
4. Long-term: inter-CCP netting

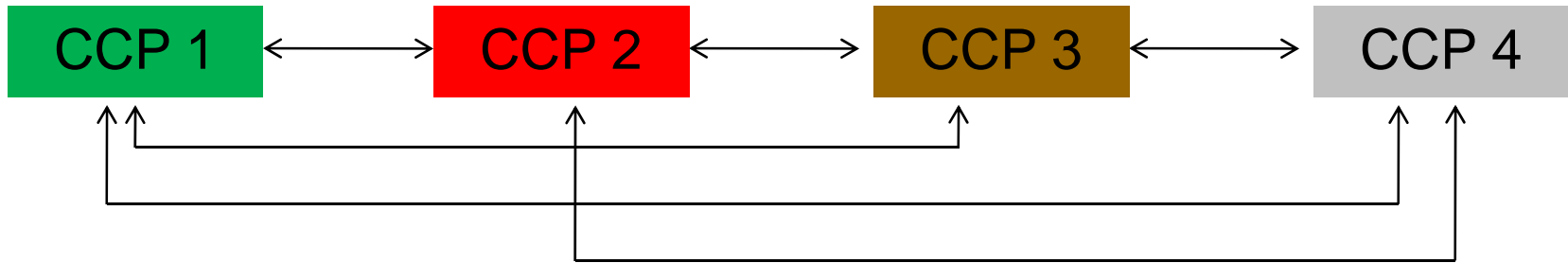


Rec 1: Augmented default fund

- Each CCP includes the exposure created by interoperating CCPs in the calculation of its default fund
- Each CCP collects additional amount required from its own participants, retaining the funds in the usual manner that it holds its default fund
- Requires collective adoption by all interoperating CCPs, but could be implemented quickly



Inter-CCP counterparty risk

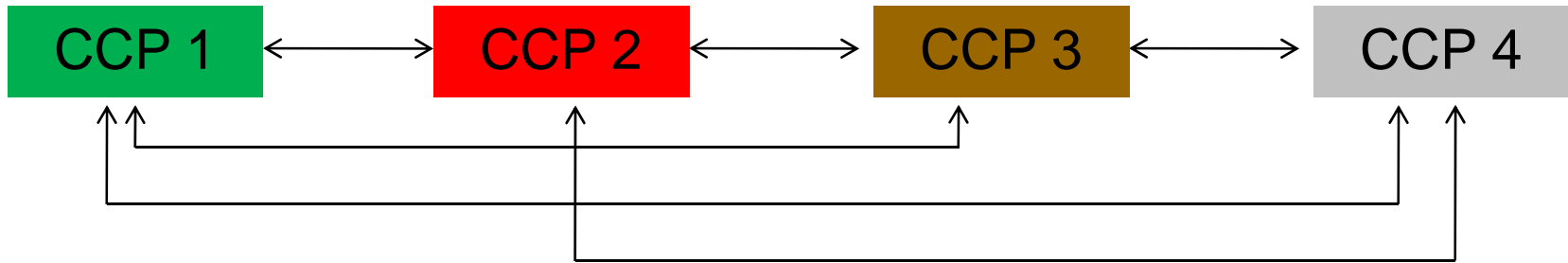


A CCP will default on its obligations to other CCPs if:

- A Participant is bankrupt, *and*
- Margin collected from Participant is insufficient to cover losses after close out of its unsettled position, *and*
- CCP has insufficient other financial resources available to cover those losses
- CCP as a result cannot meet its obligations to other CCPs



Margin exchange requirements

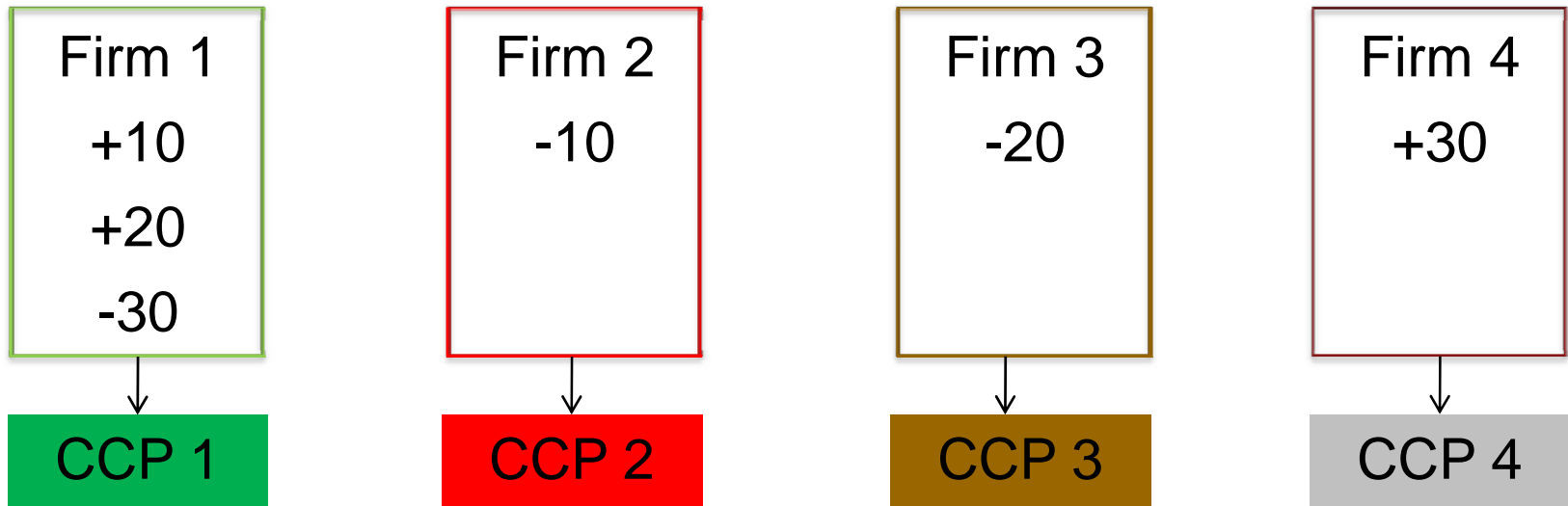


All CCPs must:

- Calculate sufficient margin required from other CCPs to cover loss in case close out of other CCPs is required
- Collect sufficient margin from other CCPs in time
- Source and provide required margin to other CCPs
- Recover own collateral if other CCPs fail



Complexity of multi-CCP margining



Firm 1 owes no margin to CCP 1, because its position is flat

CCP 1 owes margin to CCP 2, CCP 3, and CCP 4 whose customers were on the “other side” of Firm 1’s trades

CCP 1 needs to fund the unpredictable margin amounts and ensure timely payment to all other CCPs



Limitations of margin exchange

Source of funds for CCP margin exchange:

- Re-use of client margin (outright transfer, pledge to bank to collateralise borrowing, reverse-repo for securities)
- Bank guarantee
- Own capital of CCP

Margin exchange is inherently inadequate:

- Margin only covers normal market conditions, when it is generally accepted that a CCP would not fail
- In extreme and stressful market conditions when a CCP failure is likely, margin held could be insufficient cover for close-out losses. Guideline to Code of Conduct does not require CCPs to contribute to each other's default fund



Augmented default fund advantages

From interoperating CCPs' perspective:

- Easy and quick to implement
- Scalable as amount is spread among a number of Participants
- No impact on liquidity of CCP
- No possibility of a material difference in margin amounts between CCPs
- Each CCP's risk management is self-contained; no contagion, no legal risk of recovering margin provided to failed CCP
- Removes issue of "quality" of collateral, such as bank guarantees
- Removes possibility of one CCP putting another CCP in default due to inability to meet a margin call on time



Augmented default fund advantages

From Participants' perspective:

- Avoids re-use of Participant margin
- Additional contribution required from each Participant is relatively small according to EuroCCP's modelling; we suggest that the other CCPs do the same
- Contributions would be related to trading activity; small-volume firms less than high-volume firms
- Concentrating volumes in a Participant's CCP of choice eliminates collateral and margin posted at multiple CCPs, so net increase may be minimal or nil
- Interoperability makes competition possible, and benefits large and small players alike. Purely domestic users benefit from lower prices overall and market growth

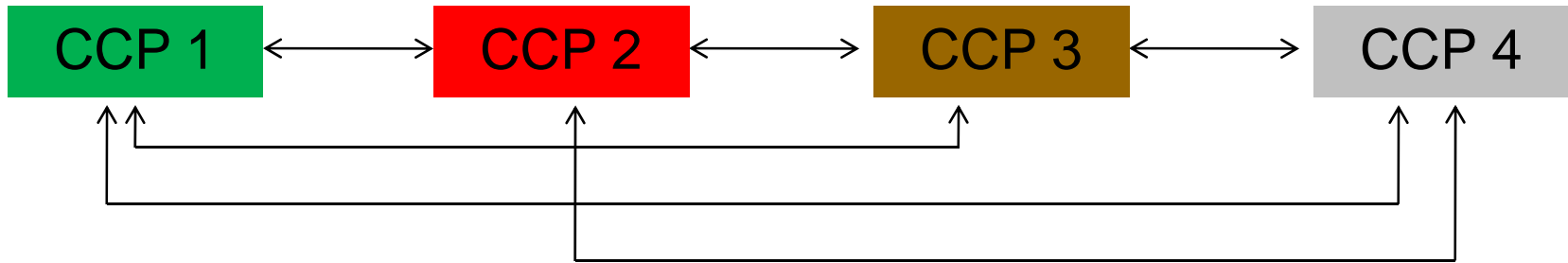


Why “survivor pays”

- A market participant using the failed CCP would already have lost all its default fund. Being a customer of a surviving CCP is comparatively a better position as the participant’s default fund contribution has the potential of remaining intact.
- Participant contribution to default fund is not loss-sharing unless there is a CCP failure, under extreme market conditions.
- An augmented default fund is relatively low-cost for CCPs to operate and administer compared to margin exchange. All market participants ultimately pay for excessive costs.



Rec 2: Interoperability Convention



Advantages of a single, public agreement:

- Allows CCPs to know their exposure arising from arrangements interoperating CCPs have with others
- Allows market participants to know the additional risks their CCPs are exposed to
- Allows venues, other CCPs, market participants and regulators to know what are the contractual obligations that could affect interoperating entities, and act quickly when there is a problem
- Reduce potential for legal risks when problems arise



Bilateral contracts add risk & complexity

<u>No. of Interoperating CCPs</u>	<u>No. of Bilateral Agreements</u>	
2	1	} Some concluded and others in progress
3	3	
4	6	
5	10	} Barrier to pan-European interoperability
6	15	
7	21	
8	28	
9	36	

To simplify interoperability and make it safer, CCPs should, as soon as practicable, replace multiple bilateral agreements with a single interoperability convention that is made transparent to trading venues, market participants, and regulators.



Interoperability Convention Overview

A. Principles & Procedures

1. Assets cleared
2. BCP
3. Buy-ins
4. Cash settlement
5. Change management
6. Clearing fund / loss sharing
7. Communications
8. Contract governing law
9. CSD instruction
10. Fines, penalties, settlement, clearing and other costs
11. Holiday schedule
12. Margin
13. Netting algorithms
14. Nonstandard nets
15. Settlement date convention
16. Settlement location
17. Settlement obligation cancels
18. Shaping for corporate actions
19. Splitting
20. Static data validation
21. Reconciliation
22. Required approvals
23. Trade cancels / corrects
24. Trade validation, rejection, and point of irrevocability
25. Trading hours

B. Change Management

1. Change Management Principles

- Peer-to-peer relationship, per Code of Conduct; no CCP able to impose changes that cause material adverse business or economic impact to others
- CCPs that have agreed changes have a duty towards CCPs not part of the agreement but are affected by the changes

2. Change Management initiation, consultation, decision

- Changes to Principles
- Changes to Procedures
- Urgent issues
- Decision-making process in the absence of agreement

C. Legal, commercial, connectivity and technology tasks



Rec 3: Remove commercial barriers

- Investment is sub-optimal if interoperability remains patchy due to commercial barriers, limiting full choice.
- Trading venues hold the power to appoint CCPs, but market participants pay for usage: interests may not always be aligned.
- All interoperating CCPs should have access to trade feeds of all trading venues any CCP in the interoperating group clears for.



Rec 4: Inter-CCP netting

- A long-term possibility to improve safety
- Exposure among CCPs could be reduced via multilateral netting of open obligations
- Requires a firm legal basis, automation to ensure safety
- Requires a netting agent to ensure operational efficiency



Conclusion

- New challenges require new thinking and new solutions
- Solutions must be scalable and sustainable
- Progress involves costs; long-term benefits are significant
- EuroCCP will work collectively with other CCPs to
 - advance interoperability
 - help trading venues realise market growth
 - offer real choice for market participants