FRB Chicago OTC Derivatives Symposium Panel: **CCP Loss Allocation and 'End of Waterfall' Scenarios**

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CCP R&R: Where are we and what is still needed to avoid "too big to fail"?

Industry & Regulatory Objectives: CCP Resolution and Recovery

1. ***Reduce likelihood that a CCP fails*** following a severe stress event, such as the default of multiple members in a short period of time
2. ***Reduce likelihood of market contagion following a CCP failure;*** reduce the probability that the failure of a CCP destabilizes other SIFI market participants that are members of the CCP and other FMIs
3. ***Reduce likelihood of liquidity runs following CCP stress or failure***; avoid strong and sudden loss of market confidence in the solvency or liquidity of other CCPs and thus liquidity runs from CCPs, resulting in severe stress or failure of multiple infrastructures
4. ***Reduce likelihood that public money is used*** to address CCP failure
5. ***Preserve the operation*** of the systemically important functions of a CCP following failure.

Current State - Drivers of CCP Distress and Suggested Recovery Methods

- Non Default loss – investment loss or operational risk such as fraud

1. UK CCPs proposing loss allocation model to comply with May 1 requirement to cover investment losses
2. CCP regulatory capital limited to cover other non default losses

- Default loss - after use of member default fund\assessments, the following have been discussed as possible recovery methods:

1. Full loss allocation to members beyond default fund\assessment contributions
2. IM Haircutting - incompatible with EMIR, creates the wrong incentives, pro-cyclical, conflicts with IM segregation regimes)
3. Reduction of Unpaid Payment Obligations (VMHC) – incentivizes participation in default management process, and satisfies accounting criteria for Basel III - but does NOT effectively address the basic remaining structural flaws with central counterparties that remain – these are fairly fundamental and straightforward

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Recommendations to Promote CCP Resiliency

It is known and widely discussed that CCPs commonly suffer from:

- Lack transparency to their members and other participants
- Lack a consistent stress framework amongst their peers;
- Insufficient skin in the game resulting in inappropriately aligned incentives with for-profit model; and
- Dependency upon unfunded member commitments for a portion of loss absorbency, recovery and resiliency, which creates uncertainty as to whether money will be available when it is most needed

Addressing above would preserve CCP resiliency and reduce the likelihood of a CCP failure. To this point, I would agree with some of Blackrock’s key recommendations described in its very thoughtful paper released this week:

- CCPs should be subject to a standard, publicly-disclosed stress test framework; results of which would be used to size aggregate resources
- Entire financial safeguard waterfall should be fully pre-funded
- CCPs’ contribution should be risk based and should be lower of either a fixed percentage of the fund (approx. 10%) or the largest single clearing member contribution.

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Potential Approaches to CCP Resolution

1. Liquidation of CCP and cessation of clearing activities, including those viewed as systemically important:

    a) Rush to exit and closing of positions will lead to contagion

    b) Alternative CCP will need have sufficient capacity to take on new trades as members look to re-establish positions given clearing mandate

2. Pre-funded recapitalization resolution strategy – BlackRock’s paper suggesting that a CCP could be recapitalized post-failure through fully pre-funded recapitalization resources <u>is extremely thoughtful and should be fully explored:</u>

    a. Regulators would determine point of non-viability, at which time resolution and recapitalization utilizing fully pre-funded resources would be triggered

    b. Would promote and preserve market confidence, avoid pro-cyclicality, and ensure continued operations to allow opening on the business day following failure

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