

August 2015

EACH response - EBA consultation on RTS defining methodologies for the valuation of derivative liabilities

Question 7

Do you agree with the treatment of CCPs as laid down in this Article? Are the conditions laid down in this article compatible with a swift and efficient valuation of cleared derivatives within the context of a resolution process? Do you see any material risk that the treatment of CCPs as laid down in this Article could conflict with the requirements for a sound risk-management framework to deal with the default of a clearing member?

EACH believes that liabilities of a bank under resolution to a CCP should be exempted from the bail in tool. We therefore support that the consultation paper states the liabilities of a bank under resolution to a CCP are likely to fall under the exemptions from bail-in provided for under Article 44(2) of BRRD. In this sense, the following remarks should only be regarded in the case where the liabilities would not fall under this exemption.

Our members support the EBA proposal that the **early termination amount shall be determined in accordance with the CCPs' default procedures**. It is indeed vitally important to the stability of the financial markets that the Bank Recovery and Resolution Directive does not impede or disrupt the operation of the CCPs' default management processes. For EU CCPs such default management processes are designed and operated in accordance with EMIR requirements and related RTS. They include mechanisms to liquidate the positions of the defaulting member and those of its clients, as well as facilitate the portability of the positions and collateral of these clients.

EACH would like to clarify the following points:

- **Early termination amount**

The draft RTS envisages that a CCP will be able to calculate an early termination amount for the purpose of bail-in (Article 6). We believe it would be **helpful to provide a definition of the term ‘early termination amount’** to clarify that in the case of cleared derivatives contracts this is the **net amount that would result from the actions taken by a CCP to neutralise the risk associated with the defaulters’ portfolio and close out or transfer clients’ positions in accordance with its default procedures, after applying the collateral resources of the defaulter** including initial margin, variation margin and its contributions to the default fund . Therefore, the amount potentially subject to bail in would be that to be covered by the rest of the prefunded default waterfall (i.e. CCPs’ skin in the game and mutualised default fund) which are not secured by the defaulter, consistent with the exemption from bail in applicable to secured liabilities. We would also note that it is usual practice for CCPs to withhold an amount to cover potential costs and fees associated with the default management process (including legal fees) to be paid by the CCP and therefore the CCP should be able to include provision in its calculation of the early termination amount for such fees. (These costs will be taken into account when calculating the single net sum, it is not a case of holding onto collateral).

We support the proposed approach whereby the timings to achieve a calculation of the ‘early termination amount’ would be agreed (and we take this to mean a genuine agreement between the parties) between the resolution authority, the CCP and the CCP’s competent authority, taking into account the CCP’s EMIR-compliant default procedure and the resolution timeline, as indicated in Article 6(5).

It is important that the agreed timeframe takes into account the need for the CCP to act under a suitable timeline to complete its default procedures and it is not prevented to do so for the purpose of calculating the early termination amount. In addition, it is important to recognise that any timelines should build in appropriate contingencies which would allow the resolution authority, the CCP and the CCP’s competent authority some flexibility in agreeing when the CCP provides the valuation of the early termination amount. The process of agreement should be interactive and flexible.

In order to reflect the complexity of managing a default, the CCPs obligations should be on a best endeavours basis so that the CCP is only penalised where it is not using its best endeavours to honour its agreement with the resolution authority and its competent authority. We believe that Article 6(6)(a) should be amended accordingly. Given the potential impact on a CCP of invoking Article 6(6), we welcome the EBA's proposal that any decision on 6(6)(a) and (b) should, at a minimum, be taken after consultation with the CCP's competent authority.

EACH assumes that the following process will apply:

- Where a CCP has a positive early termination amount, this would be returned to the defaulter (together with the collateral) and no bail-in would apply.
- Where a CCP has a negative early termination amount, that amount would be subject to bail-in notwithstanding that the CCP will continue to apply its default procedures to cover the remaining losses with resources other than the defaulter's own collateral and default fund contribution. In particular in the limited circumstances where the calculation is performed by the resolution authority, we would like to ensure that such valuation will not be intended to be used to value the actual net loss amount on the basis of which the CCP will continue to apply its default procedures.

With regard to Article 6.1, EACH would like to clarify that the resolution authority can only determine the early termination amount as calculated by the valuer only in the circumstances described under (a) and (b) of Article 6.6.

- **Porting - Recital 19 and Article 1 (12)**

EACH notes that the definition of porting in Recital 19 and Article 1 (12) does not include the possibility of 'partial porting', which is one of the options currently used by CCPs. We would therefore suggest amending the recital and definition accordingly.

- **Default Management - Article 6(4)**

EACH considers that Article 6(4) as it currently stands constraints the CCP with regard to the way to perform its default management process. This is particularly reflected in the sentence 'to liquidate or completely re-hedge the positions of the defaulting clearing member' which effectively restricts the reality of the default management process.

There are indeed two key components of the Default Management Process: hedging, which aims to neutralise the overall risk of the defaulter's portfolio as quickly as possible (protecting the CCP and its participants against any further market moves); and/or the auction process, which transfers the position (risk) inherited from a defaulted clearing member to other members willing to absorb it. The hedging and auction processes may be used to differing degrees depending on the product or market being cleared. Other possibilities different to hedging or auctioning may be used in certain circumstances.

EACH proposals

- We believe it would be helpful to provide a **definition of the term 'early termination amount'** to clarify that this is **the net amount that would result from the actions taken by a CCP to neutralise the risk associated with the defaulters' portfolio and close out or transfer clients' positions in accordance with its default procedures, after applying the collateral resources of the defaulter** including initial margin, variation margin and its contributions to the default fund.
- **We support the proposed approach whereby the timings to achieve a calculation of the 'early termination amount' would be agreed (and we take this to mean a genuine agreement between the parties) between the resolution authority, the CCP and the CCP's competent authority.**
- **EACH also invites EBA to consider that the timeline to determine the early termination amount takes into account the need for the CCP to act under a suitable timeline to complete its default procedures and the fact that it will closely depend on the products cleared.**
- With regard to Article 6.1, EACH would like to clarify **that the resolution authority can only determine the early termination amount as calculated by the valuer only in the circumstances described under (a) and (b) of Article 6.6.**
- **EACH suggest amending the recital 19 and definition 12 of porting to include partial porting.**
- **EACH suggests the deletion of the sentence 'to liquidate or completely re-hedge the positions of the defaulting clearing member' of Article 6(4) in order to ensure that it reflects the different measures that a CCP may take in a default management process.**

- **Notification to close-out derivatives contracts and instruction to provide early termination amount**

EACH also understands from the draft RTS that the resolution authority will have the right to initiate the close-out of derivative contracts. **The CCP will then be instructed by the resolution authority to provide an early termination amount for all derivative contracts in the relevant netting set in accordance with the CCP's default procedures (Article 6 (2) & (3)).** In order to ensure adequate risk management, EACH suggests slightly amending Art.6 (2) in order that the resolution authority would consult the CCP and its competent authority before the notification to close-out takes place.

Question 11

The possibility to produce an early determination is available also in relation to claims of a CCP. In this case the final valuation will reflect the CCP claim as determined pursuant to Article 6, on the basis of the CCP default procedures if provided under the conditions of that Article.

Do you consider it appropriate to also allow an early determination in relation to CCP claims?

EACH believes that an early determination should only be allowed in certain cases. In particular, **early determination should only apply where a CCP has failed to instigate its default process or has been negligent in pursuing its default process.** The imposition by a resolution authority of valuations part way through a default process that a CCP is diligently pursuing could cause significant losses to the CCP and could prevent the CCP from accurately calculating its early termination amount. The imposition of a valuation would also not be used by the CCP in calculating the amount of the defaulter's collateral it needs to apply to meet its losses and so it may result in the defaulter receiving less returned collateral than may have been anticipated in calculating its assets or in a CCP being bailed in for more than it is owed. A resolution authority is also highly unlikely to be able to accurately predict the value for any set of trades that a CCP may realise through its default processes. It is also important in this regard that any time limit agreed for the CCP to provide the bail-able amount as part of the CCP's default process properly takes into account a realistic estimation of how long the process may take.

The requirements in Article 7 seem to reflect the requirements under Article 6, whereby CCPs should perform the valuation of cleared derivative contracts in accordance with its default procedure, but, in limited circumstances, the resolution authority may intervene early to perform its own valuation estimate. Therefore **we do not see any differences in principle between the objective of Article 6 and 7**. However, we support the approach in Article 7(3) which specifies that **the resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6**.

Question 12

If so, do you consider that, with regard to CCP claims, resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6? In that case, how do you assess the risk that the CCP determination process could hold back the finalisation of the bail-in process also for other claims? Alternatively, does the assessment of difference in treatment pursuant to Article 74 of the BRRD provide a sufficient safety net for CCPs?

Yes, with regard to CCP claims **EACH believes that resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6**. Given the transparent and organised default management procedures of CCPs, EACH does not believe that such determinations will present a substantial risk to finalisation of the bail-in process.