

Statement by Mr. Terence McCormick, Chief Risk Officer at BNP Paribas Securities Services at the occasion of the public hearing on the recovery and resolution of CCPs in the ECON Committee, European Parliament.

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22 March 2017, Brussels.

Dear Mr Chairman, honourable Members of the European Parliament,

Thank you for your invitation to address this Committee on the important subject of CCP Recovery and Resolution. I shall use this opportunity to present the perspective of a clearing member. BNP Paribas is a global provider of clearing services, ensuring client and house access to over 60 CCPs worldwide. We provide access to clearing segments spanning across all types of financial instruments, from cash clearing to classic equity-based derivatives through repo and OTC derivatives.

We welcome the initiative of the European Commission to establish a recovery and resolution regime for CCPs. Before entering into a more detailed analysis it is important to stress that much has already been achieved to ensure that a recovery or a resolution of a CCP in Europe is a very unlikely scenario. The implementation of Basel III has significantly increased the robustness of the clearing banks, by raising capital levels in general and by imposing capital charges for CCP exposures specifically. The EU Banking Recovery and Resolution Directive has laid foundations for the management and orderly wind-down of troubled banking institutions, ensuring that a resolution of a bank is not synonymous with default, but that it can be orderly managed and would not cause unwanted domino effects in financial system and its infrastructures.

Against this background, a recovery and resolution regime for CCPs should be informed by proportionality, and bear in mind that prevention is always more efficient than the cure. EMIR established the first set of requirements to make EU CCPs resilient to various types of risks, but more can be done to ensure that the European CCPs are robust and appropriately equipped to withstand challenges. More robust, well capitalised, and appropriately governed CCPs with appropriately sized skin-in-the-game will be less likely to run into crises. This regulation is meant to address the extreme case scenario, and we should keep this in mind when defining its instruments and rules.

Apart from proportionality, we believe that the proposed regulation should build on two other key principles: transparency and efficiency.

Transparency is paramount for a recovery or resolution to be successful, as the best recovery is a market-based recovery. In order for it to succeed, the market participants need to have a clear view of the process and of the risks they would incur along the way. The regulation should establish objective indicators as to when resolution should commence. The Commission proposal is very good in that respect. We consider that entry into resolution

should not be automatic or presumed, and that some level of flexibility for the Resolution Authority is needed as to whether to trigger the resolution.

With respect to CCPs, it would be up to them to determine the entry point into recovery. It is crucial that the CCPs communicate on the recovery trigger criteria, and in contrast to an Authority-led resolution, flexibility is not advised here. The clearing members need to know precisely at which moment their exposures and risk management would “switch“ from “BaU” to crisis mode. In order for the recovery to be quick and successful, uncertainties must be reduced to an absolute minimum, and the sequence of events must be clear.

In the interest of transparency, fair procedures should be established for the involvement of the clearing members in the establishment of the recovery plan and of the resolution plan. The regulation should establish a minimum list of issues on which users should be mandatorily consulted and how their views should be taken into consideration by the CCP and the competent authority or resolution authority.

Apart from clarity about triggers, two core elements of risk management must be clear to the CCP members at any point in time: first, the level of the current exposure must always be possible to assess; second, the maximum quantum of potential losses should be known. Consequently, all recovery and resolution tools must have appropriate caps and be limited in time, and there needs to be a clear cap on total individual losses. In accordance with the „No Creditor Worse-Off“ principle, losses should not be allocated beyond a clearly defined and unconditional counterfactual. We believe that there should be single counterfactual for both default and non-default losses, and that it should be the insolvency of the CCP according to the applicable law.

The third principle I wish to draw your attention to is efficiency.

We agree with the simplified approach allowing for a CCP-led recovery and an authority-led resolution. However, they should be based on a clear and transparent CCP rulebook and a transparent resolution strategy. This will allow for the flexibility needed to address the different risk profiles and business models, and should allow to keep things simple, timely, and appropriate.

Efficient recovery or resolution should preserve the value in the CCP, safeguard the financial stability, and minimize losses while distributing them in a fair manner. In order to achieve these objectives, recovery and resolution plans should appropriately align the incentives of all involved stakeholders. They should respect that the defaulter always pays first, losses are allocated broadly, and no moral hazard is created.

The toolbox found in the proposal is a good approach and it should be completed by number of safeguards:

- There should be a clear distinction between tools for default and non-default losses. Only the losses resulting from a clearing default should be mutualized. Non-default losses should accrue exclusively to the CCP and its shareholders and guarantors. Under no circumstances should the waterfall or contingent mutualised resources be used to cover losses non related to a clearing default.

- CCPs should contribute to loss-sharing through a second layer of Skin In The Game, to be used after the exhaustion of the waterfall. Users should not be asked to provide additional contingent funding before the CCP has done so too.
- The initial margin should be explicitly protected from the bankruptcy of the CCP, and should in no circumstances be used to cover any losses other than those caused by a default of a user to whom it belongs. IM is the most important line of defense of the CCP against any subsequent default and must remain intact.
- Variation Margin Gains Haircut should be a loss allocation tool and be applied after the quantum of losses has been determined. It is not an emergency liquidity tool. Where VMGH is implemented and the return of the CCP to normal business is successful, users should be compensated for their haircut from subsequent CCP profits through a senior debt claim.
- No forced allocation of positions should be envisaged. Partial tear-up of positions is a more appropriate tool for rebalancing the CCP book, but it should be used only after at least one round of auctions has taken place.
- Finally, mutualized resources for CCP default risk management should not be used for the recapitalization of the CCP. The threat of becoming a shareholder in a failing or failed CCP, or even blunt assessment for the sole purpose of recapitalizing the CCP or rebuilding the CCP SITG will only create perverse incentives and cause a possible rush to exit. In this vein, compensation in the form of CCP equity is inappropriate, and a recapitalization of the CCP by its users should be voluntary.

Ladies and gentlemen thank you for your attention and I am happy to answer your questions.