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Impact of Recovery and Resolution Tools on Members and Clients

19.12.2022

V1.0

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1. Introduction

1.1 Purpose of this document & target audience

This document is intended for ECCs Clearing Members (CMs), including DCP Clearing Members, Non-Clearing Members and clients.

Following Art. 9 (23) of Regulation (EU) 2021/23 on a framework for the recovery and resolution of central counterparties (CCP Recovery and Resolution Regulation – CCP RRR), Clearing Members are obliged to inform their clients on the measures a CCP can take in recovery with a potential impact on them. In ECCs terminology, the CCP RRR term “client” includes also ECCs Non-Clearing Members as clients of a Clearing Member.

To facilitate this information process, this document contains:

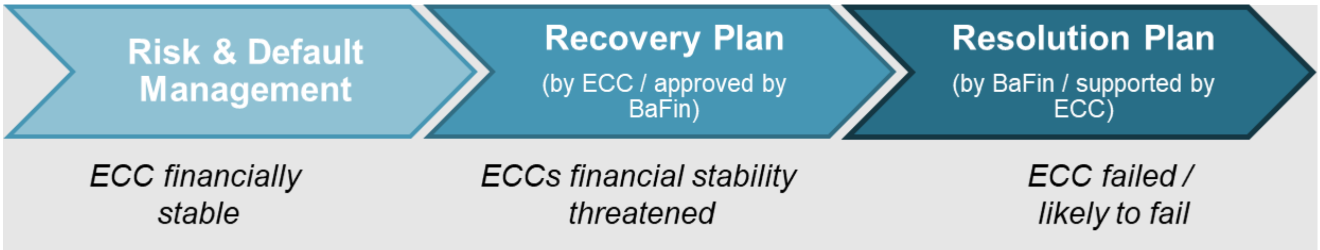
- A description of ECCs recovery tools with a potential impact on Clearing Members, Non-Clearing Members and clients as identified by ECC;
- The general background regarding ECCs recovery planning and corresponding governance arrangements.

1.2 Regulatory Background

On 22 January 2021, the Regulation (EU) 2021/23 on a framework for the recovery and resolution of central counterparties (CCP Recovery and Resolution Regulation – CCP RRR) was published in the Official Journal of the European Union. The Regulation entered into force on 11 February 2021. Most of its provisions apply from 12 August 2022[1].

The objective of recovery and resolution planning for CCPs is to define measures to be taken in extreme but plausible events of financial distress and ensure the continuity of key critical functions, while excluding the use of public resources and preserving financial stability. While the recovery plan has to be established by European Commodity Clearing AG (ECC) in coordination with the recovery and the resolution authority, the responsibility for resolution plan lies with the resolution authority (supported by required input provided by ECC and to introduce the respective tools in the Clearing Conditions).

[1] With the exception of: Article 95 which applies from 4 July 2020; Article 87(2) which applies from 11 February 2021 and Articles 9(1), 9(2), 9(3), 9(4), 9(6), 9(7), 9(9), 9(10), 9(12), 9(13), 9(16), 9(17), 9(18), 9(19), 10(1), 10(2), 10(3), 10(8), 10(9), 10(10), 10(11), 10(12) and 11 which apply from 12 February 2022; Articles 9(14) and 20, which shall apply from 12 February 2023.



According to Art. 9 (23) CCPRRR, Clearing Members (CMs) shall communicate to their clients in a clear and transparent manner if and in what way measures in the CCP's recovery plan and potential resolution measures by the resolution authority may affect them. Against this background, ECC provides the following overview of the recovery and resolution tools that may impact CMs in order to enable them to fulfil their requirement under Art. 9 (23) CCPRRR. Additionally, it should be highlighted, that the respective tools are also part of ECCs Clearing Conditions.

ECC only has a principal-to-principal relationship with the CMs and does not intervene in the CMs' relationship with their clients. The impact of any recovery or resolution action on the CMs´ clients will therefore depend on the arrangements set out in the legal relation between the CM and its clients.

1.3 Recovery Plan Governance

ECC maintains a recovery plan. documenting ECCs processes to be activated in situations where ECCs financial viability, including the fulfillment of its minimum regulatory capital requirements, is significantly threatened.

The activation of the Recovery Plan means that all preceding risk management tools and capacity are exhausted or ineffective. The CCPRRR requires ECC to prepare for such events; specifically for:

- The default of the two largest Clearing Members in extreme but plausible market conditions, exhausting all pre-funded collateral and Default Fund contributions.
- The default of the two largest Clearing Members and inability to establish a matched book in time.
- Liquidity issues in default events or non-default events.
- Significant non-default event losses due to any type of risk other than a Clearing Member default event (e.g. operational risks including legal and cyber risks).
- Significant losses due to a combination of default and non-default events.

The recovery plan contains governance structures, recovery indicators, the monitoring, escalation and communication processes as well as the recovery tools.

The recovery tools with potential impact on external stakeholders, including Clearing Members and Non-Clearing Members, have been presented to ECCs Risk Committee and, via public consultation and ECCs Clearing Working Group, to all interested stakeholders. Any change to such tools is again presented to the Risk Committee and consulted.

ECCs recovery plan is reviewed and approved by ECCs competent regulatory authority and the EMIR College of regulators as well as ECCs resolution authority and the CCP RRR Resolution College. Should either the regulatory or resolution authority have doubts on the feasibility or effects of the recovery plan, they can require ECC to change the recovery plan, including the tools foreseen.

Both authorities have to be informed by ECC should ECC activate the recovery processes. Also, the recovery and the resolution authority can intervene if ECC intends to apply any recovery tool. The recovery and the resolution authority can also order ECC to apply a recovery tool to restore the financial viability.

2. Recovery Options

2.1 General information

ECCs recovery options consider its nature, size of business as well as its interconnectedness with the financial system and includes capital and liquidity raising options in order to restore ECCs soundness. Recovery tools can be applied if ECC experiences 'a significant deterioration of its financial situation or a risk of breaching their capital and prudential requirements' (in so called 'recovery situations') according to Art. 9 (1) CCPRRR.

In its role as CCP, ECC differentiates between "default" related and "non-default" related recovery instruments. Default related instruments target to manage the consequences of a Clearing Member default scenario, e.g. establish a matched book or cover financial damages from the default. In its default management process, ECC defines those tools as recovery tools which are mandatory, e.g. go beyond members voluntary action at the time of default or restrict members rights or implement additional financial obligations. Non-default related recovery instruments aim at preserving or regaining the financial stability of ECC in a classical sense and are applicable to situations where losses or liquidity shortfalls are not caused by default of a Clearing Member, e.g. "non-default" scenarios.

The recovery options currently foreseen in ECCs recovery plan which impose financial obligations or additional risk upon members are:

Tool	Estimated potential impact on the group of:		
	Clearing Members	Non-Clearing Members	Clients
Default Events			
Minimum Cash Quota	Direct	None	None
Mandatory Auction	Direct	Direct	Indirect
Forced (Position) Allocation	Direct	Direct	Indirect
Partial Tear-Up	Direct	Direct	Indirect
Additional Contribution to the Default Fund ("Assessment Cash Call")	Direct	None	None
Non-Default Events			
Investment Loss Distribution	Direct	None	None

Aside from application of the minimum cash quota, each recovery option triggers utilization of ECCs pre-funded, additional dedicated own resources (Second Skin-in-the-Game - SSITG) to cover incurred losses beforehand.

The amount of ECCs SSITG is published on ECCs website:

(https://www.ecc.de/en/risk-management/lines-of-defense).

2.2 Option increase liquidity in the default waterfall

Recovery Option	Impact for Clearing Members
Minimum Cash Quota	*Background* As most CCPs, ECC relies on member cash collateral as main source of liquidity for default events. ECC does not impose minimum cash requirements regularly. However, if members chose to provide large shares of their collateral in the form of (pledged) securities, liquidity might be insufficient to cover stress losses. Therefore, ECCs Clearing Conditions foresee the possibility to introduce a Minimum Cash Quota for margin collateral and default fund contributions. *Process* If the relevant recovery indicators are breached, ECC would request Clearing Members to maintain a minimum cash ratio to a specified target date. The minimum cash ratio will be the same for all Clearing Members. *Impact on members and clients* Clearing Members are requested to maintain a minimum cash quota and / or requested to exchange securities collateral for cash collateral. The cash or swap of collateral has to be completed within one day of ECCs request. For further information please refer to section 3.4.6 of ECC Clearing Conditions.

2.3 Options to establish a matched book in case of a default event

Recovery Option	Impact for Clearing Members, Non-Clearing Members and Clients
Mandatory Auctions	*Background* As part of its Default Management Process, ECC relies primarily on the tool of close-out netting and voluntary auction to re-establish a matched book. A mandatory auction can be declared by ECC if at least one voluntary auction has been held and was insufficient to sufficiently reduce the risk in the default portfolio. The goal of the mandatory auction is to increase auction participation, increasing the competitiveness of the auction approach. Also, all participants shall be given a look at the portfolio, the opportunity to bid on the portfolio and gain positions at their own price offering, before ECC would have to apply to position allocation tools (see below). Non-utilization of the mandatory auction by ECC increases the probability that ECC is not able to establish a matched book, that resources in the default waterfall are fully consumed and that ECC would finally not be able to honor any of its payment obligations to active members. *Process* Clearing Members and Non-Clearing Members holding own or client positions in contracts in the remaining default portfolio are invited to a mandatory auction. The mandatory minimum bid size is calculated such that the remaining positions are closed if each participant just bids on its minimum bid size. The minimum bid size, per contract, corresponds at a maximum to the established net position of a member in a contract held the day before the default event. The minimum bid size is calculated pro-rata based on the relative net-position per contract. *Impact on members and clients* Participation in the mandatory auction is mandatory for the invited members. Clearing Members and Non-Clearing Member holding positions in the proprietary and client accounts with contracts that are part of the mandatory auction have to submit valid bids at least in volume of their minimum bid size. Depending on the overall auction result and quality of individual bids, the positions will change due to the participation in the mandatory auction.

	As a consequence of changed positions, there will be changed initial margin requirements and variation margin payments at the next business day as well as a changed risk profile of their portfolio. For further information please refer to section 3.11 of ECC Clearing Conditions.
Forced Allocation	*Background* Forced allocation is a position allocation tool in the meaning of Art. 28 and a tool to restructure contracts and to reduce risk in the meaning of Art. 15 Annex A CCPRRR. ECCs Management Board can decide to apply Forced Allocation after at least one voluntary and one mandatory auction has been held and both approaches were insufficient in closing out all positions in the default portfolio. The objective of Forced Allocation is to establish a matched book. The option allocates all open positions remaining in ECC's book to those members of ECC holding a position in a contract which is part of the remaining default portfolio. Also, the tool shall provide strong incentives to Clearing Members and Non-Clearing Members holding positions in a contract which is part of the default portfolio to support ECC in the default management process and the default auction. *Process* Clearing Members and Non-Clearing Members holding own or client positions in contracts that are part of the Forced Allocation will get allocated positions up to their minimum bid size as notified in the mandatory auction invitation, considering the positions a member has successfully bid on in the preceding auctions. Thereby: 1) Participants who have not submitted bids in the mandatory auction are allocated first 2) Thereafter participants which bid outside the fair market price second, 3) Thereafter remaining participants, if any. The allocation of positions into the position accounts occurs overnight at the settlement price established by the partner exchanges. *Impact on members and clients* Depending on the overall auction result and each Clearing Members and Non-Clearing Members individual participation in the mandatory auction, the positions will change. As a consequence of changed positions, there will be changed initial margin requirements and variation margin payments at the next business day as well as a changed risk profile of their portfolio.

	For further information please refer to section 3.11.8 of ECC Clearing Conditions.
Partial Tear-Up (PTU)	*Background* Partial Tear-Up is a recovery tool in the meaning of Annex A No. 15 (vi) CCPRRR and a position allocation tool according to Art. 28 and 29 CCPRRR. The objective of the Partial Tear-Up is to establish a matched book in case of a significant Clearing Member default event after voluntary and market equivalent measures have failed. ECCs Management Board can decide to apply Partial Tear-Up after at least one voluntary auction has been held and was insufficient to close out all positions in the default portfolio. The tool is designed such that exactly (and only) a number of opposing contracts to the remaining default positions necessary to re-establish a matched book in a default event is resolved ("torn up"). In comparison to Forced Allocation, PTU resolves (closes) only existing positions and does not allocate new positions to members. The option closes all open positions remaining at ECC's book. Also, the tool shall provide strong incentives to Clearing Members and Non-Clearing Members holding positions in a contract that is part of the default portfolio to support ECC in the default management process and the default auction. *Process* Partial Tear-Up will close a number of existing contracts at the non-defaulting clearing members which exactly match the opposing leg in the remaining open contracts in the default portfolio. The number of positions closed in a specific contract at a remaining clearing member corresponds to the clearing members' pro-rata share in the relevant net position among all other remaining clearing members. The Clearing Members pro-rata amount per contract will be distributed to the positions accounts (e.g. the proprietary, agency and non-clearing member position accounts) under each Clearing Member also on a pro-rata basis. The price at which a contract is terminated will be the settlement price at the day of termination as determined by ECC's partner exchanges, or a matching price from the default auction in the relevant contract, if available, or a fair estimate of the market price as determined by ECC.

	Impact on members and clients Depending on the composition of each Clearing Members and Non-Clearing Members portfolio, a number of contracts will be closed in the position account. At maximum, a member will have a net position of zero in a single contract. As a consequence of changed positions there will be changed initial margin requirements and variation margin payments at the next business day as well as a changed risk profile of their portfolio. For further information please refer to section 3.11.8 of ECC Clearing Conditions.

2.4 Options to distribute losses in case of a default event

Recovery Option	Impact for Clearing Members
Recovery (Assessment) Cash Call	*Background* ECC's Default Fund Assessment Cash Call is an additional contribution to the default waterfall in the meaning of Art. 43 (3) EMIR and a recovery cash call for default related losses in the meaning of Art. 9 (14) and Annex A No. 15 (viii) CCPRRR. Its objective is to provide additional financial resources to ECCs default waterfall in case the pre-financed resources according to Art. 45 EMIR and the additional dedicated own resources according to Article 9 (14) CCPRRR are not sufficient. The cash call is based on the Default Fund contributions of the non-defaulting Clearing Members on the date before the default event. *Process* After the default fund and ECCs SSITG have been used up and further default losses remain, ECC will issue a recovery cash call notice to CMs. CM have to contribute additional financial resources to the default fund in volume of the amount specified by ECC. The amount distributes the remaining default losses proportional to the default fund contributions of the remaining Clearing Members to the group of the remaining clearing members. The amount is capped at one default fund contribution for a single default event. For multiple consecutive default events, the cap is at 3x the default fund contribution within 90 days. Funds from Clearing Members are expected to be received latest at the next business day. *Impact on members and clients* The measure does not directly impact Non-Clearing Members or Clients. The measure has a direct financial and liquidity impact on Clearing Members in the amount specified in ECCs notice. The amount is subject to the caps as explained above. For further information please refer to section 3.7.4 of ECC Clearing Conditions.

2.5 Option for distribution of non-default losses

Recovery Option	Impact for Clearing Members
Recovery Cash Call for investment losses	*Background* ECC's Recovery Cash Call is an additional contribution to the loss absorption for non-default related losses in a recovery situation in the meaning of Art. 9 (14) and Annex A No. 15 (viii) CCPRRR. *Process* For investment losses threatening ECC's financial viability, ECC would retain the first loss tranche with its Second-Skin-in-the-Game (SSITG). Thereafter, ECC requires CMs to bear the remaining losses pro-rata per currency based on the cash collateral provided by the CM. CMs will have to contribute additional financial resources, at maximum in volume of their total cash margin provided in the respective currency (for initial margin requirements and default fund contribution). *Impact on members and clients* The measure does not directly impact Non-Clearing Members or Clients. The measure has a direct financial and liquidity impact on Clearing Members in the amount specified in ECCs notice. The amount is subject to the caps as explained above. For further information please refer to section 3.4.6.2 (3) of ECC Clearing Conditions.

3. Resolution Options

The document only includes recovery option according to ECCs Recovery Plan. Currently, ECCs resolution authority BaFin has evaluated ECC as not being of systemic relevance for the financial sector and the real economy of an EU member state. Based thereon, the preferred resolution strategy for BaFin is the normal insolvency process under German insolvency law.

Nevertheless, ECC is obliged to take up the ability of the Resolution Authority to apply the specific resolution tools following Arts. 27ff of the CCPRRR. This process is currently ongoing.