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Consultation on Recovery Tools for Default Events

Introduction of Partial Tear-Up

ECC intends to change its rules regarding tools to establish a matched book in a recovery situation following a clearing member default event.

With this consultation, ECC would like to receive feedback regarding the intended changes.

Clearing members, non-clearing members and clients are invited to provide their feedback until **16th of September 2022**. The final approach to partial tear-up will be consulted with the EMIR Risk Committee before implementation.

The final rules will be subject to the standard consultation process for changes in ECC's rulebook before becoming effective.

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Background

The EU-Regulation 2021/23 (CCPRRR) foresees contract termination and position allocation rules as instruments of a CCP recovery plan (Annex A No. 15 CCPRRR) as well as part of the toolkit of the resolution authority (Art. 29 CCPRRR). The introduction of Partial Tear-Up is a step to align ECC's recovery toolkit with the requirements of the CCPRRR.

Changes

ECC intends to introduce Partial Tear-Up in its rulebook with the following core elements:

1. The term “Partial Tear-Up” (PTU) refers to termination of derivatives contracts and following cash settlement of the terminated contracts as consequence of a clearing member default event.
2. The Partial Tear-Up can be applied by ECC as a recovery tool in case ECC was not able to establish a matched book by voluntary or mandatory default auction(s) and/or market access, and if ECC experiences ‘a significant deterioration of its financial situation or a risk of breaching their capital and prudential requirements’ (so called ‘recovery situations’) according to Art. 9 (1) CCPRRR.
3. The decision to use Partial Tear-Up rests with ECC as part of its recovery plan under CCPRRR regulation. According to Art. 18 CCPRRR, ECC's competent authority may order ECC to apply the tool according to ECC's rulebook. In addition, the resolution authority can use the tool as part of the resolution plan.
4. Application of Partial Tear-Up in recovery will trigger utilization of ECC's available Second Skin-in-the-Game as an additional loss tranche after the first Skin-in-the-Game.
5. 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.
6. The number of positions closed in a specific contract at a remaining clearing member shall correspond to the clearing members' pro-rata share in the relevant net position among all other remaining clearing members.
7. 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.

Key elements of the intended changes

Decision by ECC or regulatory authorities on PTU application

The decision to apply Partial Tear-Up rests with ECC in case of a recovery situation according to Art. 9 (1) CCPRRR, or by the regulatory authority as part of the rights under the CCPRRR for application of early intervention measures. ECC will use its Second Skin-in-the-Game before PTU is applied. Before ECC would decide to resort to Partial Tear-Up, closing the default portfolio via voluntary auctions must have been deemed ineffective.

In any case, as Partial Tear-Up is a recovery (and a resolution) tool, ECC's regulatory authority:

- will be informed on the planned utilization of the tool by ECC,
- has the right to require ECC to apply Partial Tear-Up in line with is recovery plan or the authorities own resolution plan,
- has the right to require ECC to abstain from application of Partial Tear-Up in a recovery situation.

Exact match of contracts

ECC intends only to close the minimum number of contracts necessary to (re-)establish a matched book. A full closure of all positions in a particular contract, or even a whole product group, is not foreseen. If members and ECC's partner exchanges deem the contract or commodity not to be viable for trading and / or clearing after the default event, an orderly wind down of the product group can be initiated after the immediate threat to ECC's financial viability is managed. However, this is not part of the recovery process, and financial resources of members are not foreseen to cover such orderly wind down.

Pro-rata calculation of contracts to be closed at the Clearing Member level

There are three levels at which the number of contracts to be closed can be calculated: The clearing member, the collateral account (e.g. segregation level) and position accounts (e.g. client / trading participant level).

The pro-rata amount will be calculated at the clearing member level. This has the advantage that clearing members managing actively position concentrations on the level of their overall portfolio vis-à-vis ECC would less be subject to PTU than members without such approach to their own risk management. It considers the risk management effort of the clearing member posing lower concentration risk vis-à-vis the system of all clearing participants. Furthermore, ECC intervenes less in the risk management of the clearing member towards its clients and non-clearing members with this approach to PTU. It also accounts for clearing members having supported ECC in the default auctions on the respective contracts subject to PTU. As standard operational process, the clearing member pro-rata amounts will be distributed to the single position accounts under the clearing member (e.g. prop, clients, non-clearing members) on a pro-rata basis, too.

Price at which PTU takes place

One important point is the rule for the price at which contracts subject to PTU are closed. There are three basic requirements for such rule:

1) The price used in the PTU shall resemble a close estimate of the fair market value of the contract at the time of the tear-up.
2) A rule systematically discriminating either the mutualised financial resources of remaining clearing members or resources of members affected by the PTU must be avoided.
3) The rule shall not lead to a “winners curse”, e.g. placing members who have supported ECC in a close-out auction at a sure disadvantage in comparison to members which did not bid competitively in an auction.

If Partial Tear-Up is applied after the end of a trading day, the settlement price is a reasonable choice. Viable alternatives can be the price established at the close-out auction, or a current market price or model price as determined by ECC. This depends on the market situation, the availability of settlement prices from the partner exchanges and time of application of PTU. Therefore, the rule should allow required flexibility for ECC to handle the default situation.

ECC does not favor one price over the other ex-ante. Instead, the choice for any of the price sources is highly dependent on the specific circumstances in a particular recovery situation following a default event. The price for the cash settlement following PTU will be determined by ECC considering the best estimate of the fair market value of the contract at the time of the tear-up.

Questions to participants

ECC welcomes any feedback to this consultation, which any interested party can give until 16th of September via the following survey link:

[ECC consultation on Recovery Tools](https://forms.office.com/r/55sTt5dmKR)

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… or just follow the QR-code: