

Clearing Circular 32/2022

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News

Physical
Settlement

Financial
Settlement

Risk
Management

Information
Technology

Consultation on Recovery Tools

Introduction of a Second Skin-in-the-Game and its application in default and non-default loss situations

ECC intends to implement rules regarding usage of pre-funded, additional dedicated own capital of ECC in recovery situations.

The proposal is a step to align ECC's rulebook with the requirements of EU-Regulation 2021/23 on the Recovery and Resolution of Central Counterparties.

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 the Second-Skin-in-the-Game and its application will be consulted with the EMIR Risk Committee before implementation.

The final rulebook changes 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 introduction of additional, pre-funded dedicated own resources (aka ‘Second Skin-in-the-Game’ - SSITG) as a specific, additional loss tranche to be applied in situations where ECC’s experiences ‘a significant deterioration of its financial situation or a risk of breaching its capital and prudential requirements’ (so called ‘recovery situations’) according to Art. 9 (1) CCPRRR.

The SSITG is an addition to the EMIR default waterfall for default events and a first loss tranche in non-default events (Art. 9 No. 14 CCPRRR).

The introduction of the SSITG is a step to align ECC’s recovery toolkit with the requirements of the CCPRRR.

The amount of ECC’s SSITG to be pre-funded is subject to the decision of ECC’s Management Board. The amount of the SSITG will always, at a minimum, correspond to the amount required under Art. 9. (14) and (15) CCPRRR and the accompanying RTS of the EU Commission regarding maintenance and calculation of the SSITG. ECC will not take the SSITG from the existing dedicated own resources, but fully dedicate additional own capital for the SSITG.

Regarding the governance structure, the application of all recovery tools, including the SSITG, is subject to the decision of ECC’s Management Board. Recovery tools posing obligations to Clearing Members are specified in ECC’s rulebook. ECC’s regulatory authority is informed before application of any recovery tool(s). In addition, ECC’s regulatory authority can require ECC to abstain from utilization of any recovery tool, or require ECC to apply a tool under CCPRRR.

Rulebook Changes

The introduction of the SSITG makes several changes to ECCs rulebook necessary, of which the core elements are as follows:

1. As general condition, the SSITG is a recovery tool. It would be applied only in case of ECC being in a recovery situation according to Art. 9 (1) CCPRRR, e.g. ECC experiences a significant deterioration of its financial situation or a risk of breaching its capital and prudential requirements.
2. In particular, the SSITG would be applied under recovery governance as follows:
 - a. in case of a clearing member default event as part of the default waterfall. It will be placed after the contributions of non-defaulting clearing members to the default fund, but before ECC can request additional contributions from the non-defaulting clearing members as currently foreseen under the rulebook.

In addition, the existing non prefunded additional contribution of ECC (pro-rata with the additional contributions of clearing members) will be set to a fixed EUR amount additional voluntary contribution of ECC. The EUR

amount is subject to the decision of ECC's Management Board. It applies over a cool-down period of 90 days, covering single or multiple default events. A replenishment of ECC's dedicated own resources within the cool-down period is counted towards the limit for the additional voluntary contribution.

- b. in case of a clearing member default event, if losses are realized using position allocation tools (forced allocation or partial tear-up) according to the rulebook, after the collateral of the defaulting clearing member and before the default fund contributions of non-defaulting clearing members.
 - c. in case of losses from non-default events other than investment losses, before ECC resorts to other regulatory capital of ECC.
 - d. in case of investment losses from investment of members' cash collateral or cash contributions to the default fund, before ECC resorts to any recovery loss allocation to clearing members for investment losses foreseen under the rulebook.
3. For investment losses threatening ECC's financial viability, ECC would retain the first loss tranche with its SSITG. Thereafter, ECC requires clearing members to bear the remaining losses pro-rata per currency based on the cash collateral provided by the clearing members.
4. If the SSITG has been applied in a default or non-default event, ECC would replenish the SSITG in line with the requirements under the applicable RTS at latest within one month after the utilization of the SSITG.
5. If ECC collects any amounts after a default or non-default event leading to application of the recovery loss allocation tools (additional contributions to the default fund, allocation of investment losses) to the non-default clearing members from the counterparty causing the losses to ECC in the first place, ECC will first reimburse the clearing members any loss contribution provided by clearing members under the loss allocation rules, pro-rata to their loss contribution, before ECC retains any of these returned amounts.

Key elements of the intended changes

Introduction of SSITG as dedicated loss tranche for recovery situations

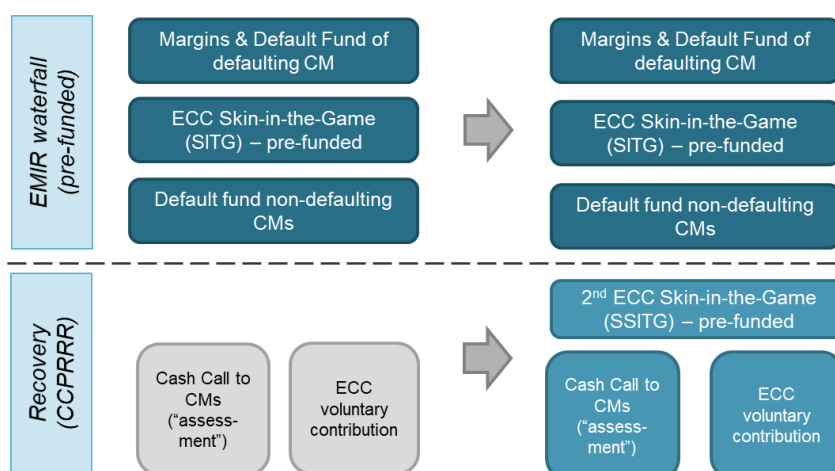
The CCPRRR requires ECC to introduce a SSITG as an additional dedicated, pre-funded own financial resource. It must have a volume between 10% and 25% of the regulatory capital requirements (Art. 9 No. 14 CCPRRR). The general target of the SSITG as formulated in the CCPRRR is to align incentives between the CCP and its members in case of unfunded financial contributions from members in a recovery situation.

This additional financial resource shall only be applied if ECC is in a recovery situation (Art. 9 No. 14 and Annex A No. 15 CCPRRR). This means, ECC's financial viability must be significantly threatened and the need to apply recovery tools is indicated.

The SSITG must be applied before ECC resorts to certain recovery tools, especially if these tools require financial contributions from clearing members or clients (Rect. 22 CCPRRR) or restructure contracts (Annex A No. 15 CCPRRR). The tools foreseen in the recovery plan that require financial contributions, directly or indirectly, from members are the additional contributions to the default fund ('assessment cash calls'), forced position allocation, partial tear-up and distribution of investment losses.

ECC's current additional contribution to the dedicated own resources

Under the current rulebook, ECC already contributes additional funds to its dedicated own resources (the first Skin-in-the-Game) on a pro-rata basis with the remaining clearing members additional contributions to the default fund. The current rule foresees up to three times ECC's first Skin-in-the-Game over a cool-down period of 90 days. For a single default one time ECC's first Skin-in-the-Game is considered.



With the introduction of the SSITG, ECC will place an additional pre-funded contribution before the clearing members additional contribution (“assessments”). ECC intends to change the current additional contribution of ECC to an “additional voluntary contribution” with the same calculation key, but limit it to a total fixed EUR amount over a cool-down period of currently 90 days and covering single or multiple default events.

Overall, the incentive structure is further strengthened. The SSITG is a pre-funded first loss tranche before clearing member additional contributions. Setting the additional voluntary contribution of ECC to a fixed amount supports transparency on ECC’s committed financial resources and the pro-rata calculation ensures a strong incentive structure also at the later stages of the default waterfall.

Utilization of SSITG for non-default losses before other regulatory capital

The target of recovery tools is to maintain ECC’s financial viability. From a regulatory perspective, this includes regulatory capital requirements calculated in accordance with Article 16(2) of Regulation (EU) No 648/2012. Therefore, the SSITG should support the maintenance of the regulatory capital in any recovery situation and not be restricted as a side condition before application of other recovery tools imposing obligations to external stakeholders.

Adaption of investment loss distribution rules

The requirement in the CCPRRR to use SSITG as first loss tranche before loss distribution to clearing members in a recovery situation makes adaption of the current loss distribution regulation regarding investment losses in ECC’s rulebook necessary.

For investment losses resulting from the investment of cash collateral, loss distribution is currently regulated per currency as a pro-rata approach between ECC and the relevant clearing members. For a clearing member, the loss contribution is limited to its total provided cash collateral per relevant currency. ECC’s total contribution is limited to 5 Mn. EUR (see ECCs Clearing Conditions, section 3.4.6).

This rule remains unchanged for situations where losses from cash investments are low and ECC’s financial viability is not threatened. The SSITG will not be applied, because the SSITG is reserved under the CCPRRR for recovery situations only. ECC’s contribution will remain on a pro-rata basis in non-recovery situations.

For recovery situations, the loss distribution of investment losses would change. ECC retains the first loss piece with its SSITG. Thereafter, ECC can require clearing members to bear the remaining losses equivalently to the current distribution key, e.g. pro-rata per accepted cash collateral currency based on the amount provided by the clearing members. The loss contribution to a clearing member would at no time exceed the amount provided in cash as collateral and default fund contribution in the currency affected by the loss.

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/Sics1CqMVa)

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... or just follow the QR-code:

