

Criteria for Fund Managers to consider when selecting an OTC derivatives CCP

Part 3 - Default management

The concentration of risk at CCPs by the various regulatory measures taken in the aftermath of the financial crisis in 2007-08 has sparked a debate about the consequences of a CCP failure, and the adequacy of the rules governing the recovery and resolution of a failed CCP. But any serious discussion of these issues must always begin with the default management process.

In an event of default, the first recourse of every CCP to recover the consequent losses is to the initial margin of the defaulting party. If the defaulting party is the underlying client of a clearing member, then the CCP simply takes the initial margin of the end-user and gives it to the clearing member to manage. At that point, the legal agreements between the clearing member and their clients will determine how any residual losses are allocated.

On the other hand, if the defaulting party is a clearing member, it is likely that other elements in the waterfall of resources stored against a default will be accessed. Once initial margin is exhausted, the default fund contribution of the defaulting member is used. This is followed by the default fund contributions of the non-defaulting clearing members. However, there can at this point also be a capital contribution to the default fund by the CCP itself. Finally, the CCP conducts an "assessment," in which it asks non-defaulting clearing members to top up their contribution to the default fund.

The ability of a CCP to force its members to make additional contributions in the wake of an assessment is questionable. Unlike initial margin, it does not actually hold the relevant assets. In stressed market conditions, in which systemic risks are becoming apparent with other CCPs conducting similar assessments, members will be understandably reluctant to contribute and perhaps unable to do so. It follows that users of CCPs should satisfy themselves that the members of a CCP are well-capitalised, and that the risk waterfalls of the CCPs they use are sufficiently robust to ensure that an assessment is conducted *in extremis* only.

In fact, if even an assessment proves insufficient to cover the loss, users of CCPs face a further risk in the shape of so-called variation margin haircutting. In this process, all in-the-money variation margin payments contributed by clearing members and their clients are subject to a levy to cover the remaining loss from the default. Because variation margin fluctuates daily in line with the profit or loss of a position, it is never held in a segregated account, making it difficult to protect users from the impact of such a process. "Variation margin haircutting is not a good thing for the end-user," says Phil Simons. "It is not the fault of the end-user that something catastrophic has happened, so why should they pay? There are better ways of addressing the problem."

Whatever its merits and demerits, the sequence in which the various resources are used by a CCP to cover losses is rich in crucial lessons for fund managers on how to assess and manage CCP risk. First, choosing a CCP which offers the lowest initial margin contribution could prove an expensive mistake in a default, because the loss will be passed to non-defaulting parties more rapidly. Secondly, the overall size of the default fund matters, and for the same reason.

Thirdly, it is important to ensure that a CCP places its own capital into the default fund ahead of any levy it imposes on non-defaulting members, to give it an incentive to manage risk prudently. Its ability to do so is strengthened by a parental guarantee, making a strong parent an important test in selecting a CCP.

Fourthly, and less obviously, the principles for financial market infrastructures published in April 2012 by the Committee on Payments and Market Infrastructures (CPMI) of the Bank for International Settlements and the International Organization of Securities Commissions (IOSCO) oblige CCPs to stress test their default fund. The CPMI-IOSCO principles recommend that the default fund be large enough to withstand the default of at least the two clearing members that would cause the CCP its largest losses.

"It is important to understand when a default fund will be exhausted, because there is considerable variation in models," explains Jaki Walsh. "Some CCPs do not have a secondary contribution by non-defaulting members. Most CCPs do not have a parental guarantee. And CCPs also stress-test their default funds to different levels of loss." She adds that, while only one CCP adheres to the minimum standard of covering the two largest participants, only one aims higher and sets a target of covering its six largest participants. Most CCPs aim to cover their four largest participants.

Conclusion

Given these many differences between the operating models of CCPs - any of which could have a significant impact on the business of a fund manager, especially in a default – it is obvious that the buy-side needs to choose the CCPs it uses intelligently and in a well-informed way.

Yet the poll conducted by COO Connect found that more than one in four managers that have already chosen a CCP did not conduct a full review and assessment of the capabilities of the CCPs they had selected. Even more surprisingly, the same poll found that many of the issues Jaki Walsh considers most important in selecting a CCP – its operating rules, account structures, and margin and default management policies – were regarded as less important criteria than products and services.

"Many buy-side firms tell me they feel they do not really have a choice of CCP," says Jaki Walsh. "They believe that either their clearing member will dictate which CCPs they use, or that they will have to use those CCPs that clear the type of swaps they trade. But the reality is that different CCPs will have a different impact on their business in a stressed market, or a default scenario. It is essential, to protect their businesses, that fund managers choose their CCPs with at least the same degree of care as they choose their clearing members."

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