CCP: European Regulations

PRESS RELASE

The National Depository has transferred to KDPW_CCP all functions related to the clearing of transactions executed on the regulated market and in the alternative trading system and the operation of the clearing guarantee system as of 1 June 2011. KDPW remains responsible for transaction settlement and central securities depository functions. The process implements world-class standards at KDPW and enhances the competitiveness of the Polish capital market. The spin-off of the clearing house from KDPW's structure derives from the National Depository Strategy 2010-2013 adopted in late 2009 and consistently pursued among others to develop a new business model of KDPW.

The KDPW_CCP clearing house established by the National Depository follows the global standards, uses the best solutions broadly recognised by global investors (clearing guarantee system, SPAN®) and complies with draft European regulations which may take effect as soon as 2012.

Current work on EMIR (European Market Infrastructure Regulation – Regulation on OTC derivatives, central counterparties and trade repositories) and CRD IV (Capital Requirements Directive IV) sets new standards for CCP clearing houses. The proposed regulations cover CCP capital requirements and contributions to the clearing guarantee system.

Working to establish KDPW_CCP, the National Depository has developed solutions which on the one hand will be consistent with EU requirements when these take effect an on the other hand do not impose excessive burden on the participants of the Polish capital market.

It is expected that EMIR will take effect in H2 2012; however, CCPs which are authorised to provide services before the effective date of the Regulation will have two years after the effective date to ensure compliance with the requirements.

As a result, KDPW_CCP will have two years to harmonise with EMIR provided that the Polish Financial Supervision Authority (KNF) authorises it as a CCP before the Regulation takes effect. In order to obtain the central counterparty status, the concept of novation must be introduced into the Polish legislation or KNF must approve the open offer mechanism. If KNF does not authorise KDPW_CCP's status as CCP before the effective date of EMIR, KDPW_CCP will be required to comply with the requirements of the Regulation as soon as it starts its CCP operation.

Regulation on OTC derivatives, central counterparties and trade repositories (EMIR)

Capital requirements for CCPs will be regulated directly by the Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (EMIR).

According to the draft EMIR, a CCP should have a permanent, available and separate initial capital of at least **EUR 5 million** or **EUR 10 million**.[1] In addition, capital together with retained earnings and reserves of a CCP should be sufficient to ensure that the CCP is adequately protected against operational risks or be proportionate to the risks of the CCP's operational scale.

According to the draft EMIR, the default fund (KDPW_CCP's clearing fund) should enable the CCP at least to withstand the default of the **clearing member to which it has the largest exposures** or of the **second and third largest clearing members**, if the sum of their exposures is greater under extreme but plausible market conditions.

According to the draft EMIR, the CCP's clearing guarantee system resources including margins, the clearing fund and other financial resources should at all times enable the CCP to withstand the default of the two clearing members to which it has the largest exposures under extreme but plausible market conditions.

Available financial resources should not include funds provided by members or other parties **at the request of the CCP** in case of a member's default, i.e., loss sharing arrangements and parental guarantees. KDPW's additional contributions to the clearing fund are a counterpart of loss sharing arrangements.

EMIR sets requirements for the sequence of activating resources of the clearing guarantee system in case of a member's default. First, margins contributed by the defaulting member should be used, followed by the defaulting member's contribution to the clearing fund. The CCP may use dedicated own funds before contributions to the clearing fund of non-defaulting members as well as other available resources.

EMIR is expected to take effect in H2 2012. A central counterparty authorised to provide its services **before the effective date of the Regulation** will have two years after the effective date to harmonise with the requirements.

KDPW_CCP will be able to use a two-year period of harmonisation with EMIR if the Polish Financial Supervision Authority approves it as a CCP prior to the effective date of the Regulation, which is of key importance to participants of the Polish market. This is closely related to the introduction of the concept of **novation** into Polish legislation or KNF's approval of the **open offer** mechanism.

[1] The Langen Report published by the Committee on Economic and Monetary Affairs of the European Parliament, which presents proposed amendments to EMIR, requires CCP initial capital of at least EUR 10 million.

Capital Requirements Directives (CRD)

The Capital Requirements Directives are the fourth amendment of Directives 2006/48/EC and 2006/49/EC in line with the work of the Basel Committee on Banking Supervision.

The proposed amendment strengthens the differences between capital requirements for transactions cleared centrally (by a CCP) and transactions cleared bilaterally. Operational risk issues will be improved in order to promote contract standardisation and electronic processing. Capital requirements under the CRD will be different depending on CCP quality determined by the structure of guarantee resources available to the CCP.

The Capital Accord Basel II provided for a 0% weight of counterparty risk for trade exposures to a CCP. Current amendments under Basel III will introduce a 2% risk weight for banks' trade exposures to a qualifying CCP. Trade exposures are liabilities to a CCP including margins and mark-to-market. The goal of the capital requirement amendments is to maintain incentives (based on required capitalisation of exposures) for banks to use a central counterparty in OTC transactions and to take account of the plausible but very low risk of central counterparty default.

Capital requirements for the risk of participation in a clearing fund are calculated differently. In order to ensure adequate sensitivity to risk, capital requirements for exposures to a guarantee fund depend on the structure of guarantee resources used in case of CCP member default. The sequence of activating resources of the clearing guarantee system plays an important role. It is recommended that a CCP uses its own funds before or in combination with guarantee fund resources contributed by non-defaulting members.

The Basel Committee on Banking Supervision published the consultative paper *Capitalisation of bank exposures to central counterparties* in December 2010. The paper presents proposed capital requirements for banks' exposures to central counterparties. The paper uses a 2% risk weight for trade exposures to qualifying CCPs and risk-sensitive capital requirements for exposures to a clearing fund.

The rules of capitalising exposures to a central counterparty drafted by the Basel Committee use the notions of "qualifying CCP" and "hypothetical capital" in reference to the calculation of the recommended default fund resources.

According to the proposal, a qualifying CCP is an entity which fulfils the conditions of the CCP definition, is compliant with the CPSS/IOSCO Recommendations and provides its bank clients with support necessary for correct calculation of the capitalisation of their exposures to the CCP. In consultations of the European Commission paper on capitalisation of exposures to central counterparties, EACH (European Association of CCP Clearing Houses) presented its opinion that, considering the fundamental consistency of EMIR requirements with the CPSS/IOSCO Recommendations, a CCP authorised under EMIR should be considered to be compliant with the recommendations.

Hypothetical capital is a theoretical value used only to determine the capital requirement, to which actual contributions or liabilities to a clearing fund are referred.

Default guarantee system resources consist of the clearing fund and the CCP's own funds (to the extent these can be used for guarantees). Pre-funded resources are differentiated from non-pre-funded resources, which are members' liabilities due in specific cases. At KDPW, non-pre-funded resources which can theoretically be used include additional contributions to the clearing fund. Such differentiation of resources translates into different capital requirements for clearing fund participants.

The resources of KDPW's clearing guarantee system currently available to cover the risk of default of a system participant include basic contributions to the clearing fund, additional contributions to the clearing fund, and own funds of the CCP or guarantor. In the light of the Basel Committee proposal, the resources will translate into different capital requirements for system participants:

- Basic contributions to the clearing fund. These contributions represent a member's exposure to be capitalised at 100% of exposure value, i.e., 100% of basic contributions.

- Additional contributions to the clearing fund. The Basel Committee proposes capitalisation of exposures at 120% of the difference between pre-funded resources of the guarantee fund and the hypothetical capital. Currently at KDPW the difference would be covered with resources funded by members as additional contributions to the fund.

- CCP own funds. These resources do not represent a member's exposure to the system, hence they usually do not generate a capital requirement for the member, with the exception of a special case where the CCP's own funds are the only resources available to reach the hypothetical capital, subject to a capital requirement at 1.6% of used resources.

In the light of the capital requirement regulations, the use of a CCP's own funds as guarantee resources offers the following benefits to CCP members:

- Own funds, which the CCP can use in the clearing guarantee system before the resources of the guarantee fund contributed by non-defaulting members, reduce the contributions to the clearing fund required from members. Contributions to the clearing fund required from members are reduced by the full amount of CCP funds used for this purpose.

- The CCP's own funds, which constitute clearing guarantee system resources, do not represent members' exposures to the system (unless they are the only system resources necessary to reach the hypothetical capital), unlike contributions to the clearing fund paid by members, which are subject to the requirement of 100% capitalisation of exposures, or resources potentially required from members as additional contributions to the fund, which are subject to the requirement of 150% capitalisation of exposures (until the hypothetical capital is reached).

CRD IV is expected to take effect at the end of 2012.

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