Guarantee Funds: Models and Best Practices

AMEDA Presentation

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Agenda

I. Regulatory environment

II. A, B, C of guarantee funds

III. Guarantee funds' requirements

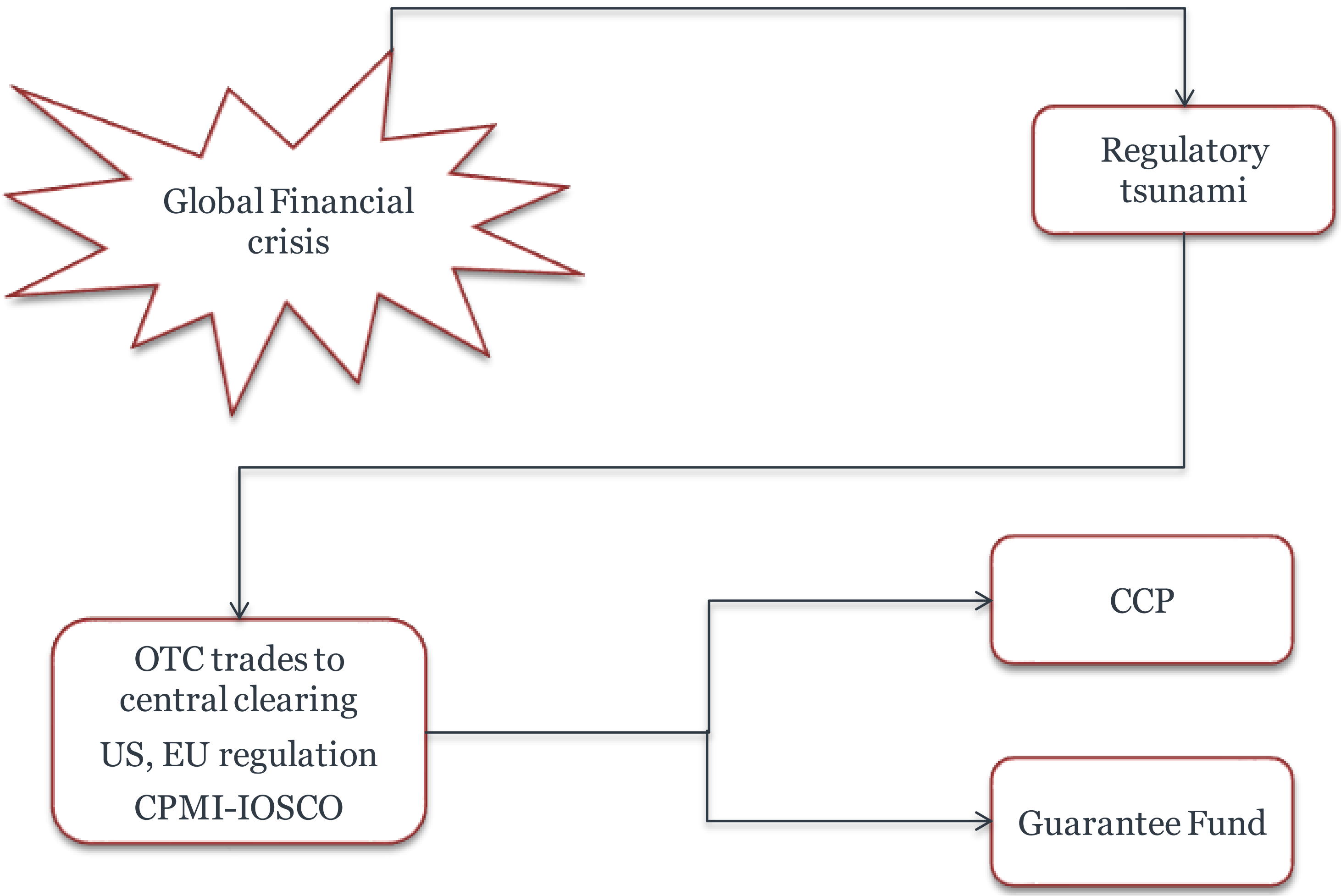
IV. Types of guarantee funds

V. Best practice model structure

VI. Waterfalls

VII. Final thoughts

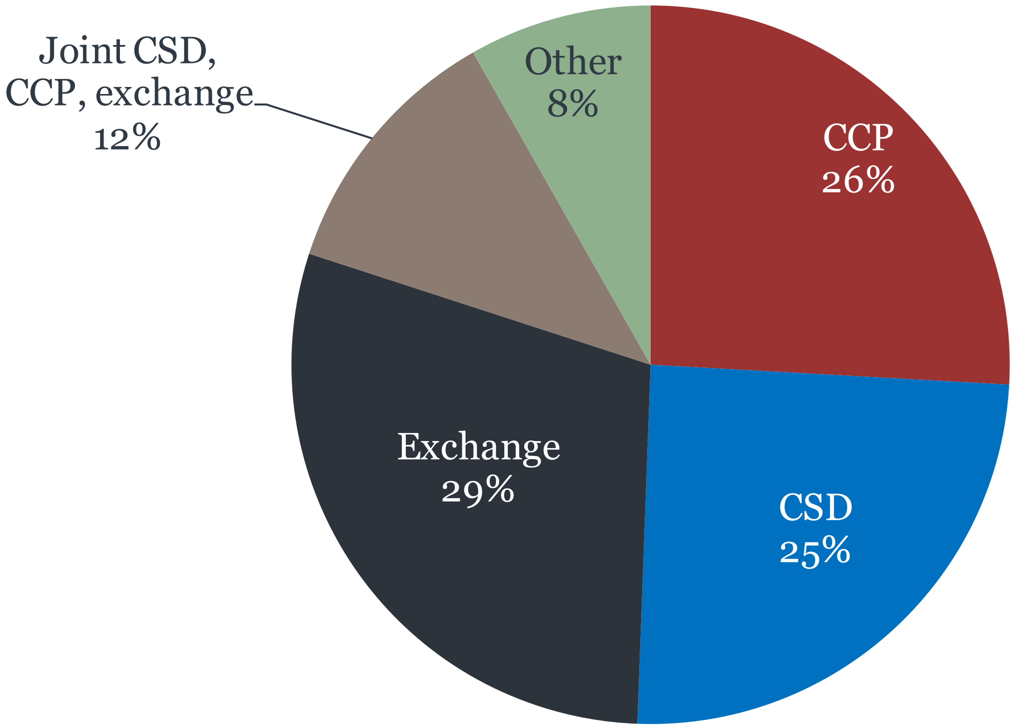
Regulatory Environment



What is the point of a guarantee fund (GF)?

- GFs are **part** of a market's defence mechanism integrated in the counterparty risk framework;
- Usually GFs are structured to mutualise the uncovered risk;
- Systemic risk is mitigated by the close out of the defaulter's positions;
- The GF can be designed to provide coverage for:
  - Brokers (majority of GFs);
  - Participants
- For some markets, it might be better to have a GF rather than a CCP;

GF management



GF requirements

What does a settlement guarantor need in order to set up a GF?

- Data – in order to be able to measure the degree of risk in the market;
- Stress testing – particular attention to methodology
  - Type of model (e.g. historic data, hypothetical scenarios, reverse testing);
  - Frequency of testing;
  - External validation (confidence and stability);
- Fund structure –member contribution (initial, regular)
- Political will;
- Market consensus
- Clear rules and regulatory framework;
- On-going monitoring (ideally real-time);

Types of GF

Defaulter pays vs. Survivor pays

- Pure ‘defaulter pays’ model - each participant cover its own risk of default;
    - Does not cover tail risk;
    - Each participant’s contribution to the fund is equal to their largest potential exposure (to a degree of confidence);
    - Default impact is contained and contagion risk is minimised;
- Pure ‘Survivor Pays’ model - "mutualises" the risk coverage by spreading it amongst not only the defaulter itself but also the surviving members of the participant fund;
    - Reducing the cost (by reducing the contributions) to all members of the participant fund;
    - Unfair – moral hazard (increased risk exposure to all participants);
- Combined model – Defaulter pays followed by survivor pays is the best practice model and widely used;

Best practice model structure

Other key elements that are best market practice;

- Liquidity – ideally all cash but practically a combination with securities (this opens the discussion on the quality of the collateral);
- Timing to access funds – the shorter the settlement cycle, the better;
- Dynamic contribution rather than fixed;
- Segregation by risk (instruments or intermediaries);
- Fund replenishment – finite based upon close out of total exposure;
- Model validation;
- On-going monitoring of risk exposure in the market as a whole;
- Stress testing (PFMIs – Principle 4 and 7);

Waterfall

Singapore CDP (capped)

Equities	Fixed Income

- Funded / Defaulter Pays:
  - Default fund, initial margin and variation margin contributions made by the defaulting clearing member
  - CDP's Contribution
- Funded / Survivors Pay:
  - Collateralised default fund contributions from non-defaulting clearing members
- Unfunded / Survivors Pay:
  - Contingent default fund contributions from non-defaulting clearing members
  - Insurance (If available at the time)
  - Any other contributions to the default fund

Hong Kong SCC (uncapped)

Equities	Bonds

- Funded / Defaulter Pays:
  - Margin and other collateral of the defaulter
  - Defaulter's own default fund contribution
- Funded / Survivors Pay:
  - Interest or any other sums accruing to the fund assets
  - CCP's own reserves (around HKD 120 million)
  - Basic Contributions from non-defaulting members
  - Dynamic Contributions from non-defaulting members
- Unfunded / Survivors Pay:
  - Replenishments from non-defaulting members

Final thoughts

Other key elements that are best market practice;

- More markets are being guaranteed (beyond exchange traded to OTC);
- Ideal solution is a combined dynamic risk based model;
- The evolution of the guarantee mechanism has been towards CCPs;
- CSDR may force European CSDs to cover non-CCPs transaction;
- International standards have been introduced for guarantee fund management for the first time;

Thank you

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