



**BME CLEARING response to the FSB PUBLIC
CONSULTATION**

**“FINANCIAL RESOURCES TO SUPPORT CCP
RESOLUTION AND THE TREATMENT OF CCP
EQUITY IN RESOLUTION”**

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FINANCIAL STABILITY BOARD PUBLIC CONSULTATION ON “FINANCIAL RESOURCES TO SUPPORT CCP RESOLUTION AND THE TREATMENT OF CCP EQUITY IN RESOLUTION”

I. INTRODUCTION

BME CLEARING provides central counterparty services in Spain. BME CLEARING has been authorized in accordance with the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012, on OTC derivatives, central counterparties and trade repositories (EMIR). In accordance with EMIR, BME CLEARING has received, on 16 September 2014, the authorization of its competent authority, the Comisión Nacional del Mercado de Valores (CNMV), to provide clearing services as a Qualified Central Counterparty (QCCP).

BME CLEARING is therefore included in the list of CCPs authorized to offer services and activities in the European Union, published by the European Securities and Markets Authority (ESMA).

BME CLEARING runs the Central Counterparty (CCP) under the following segments:

- Financial Derivatives
- Public Debt Repos
- Energy Derivatives
- Interest Rate Swaps
- Equity

BME CLEARING would like to thank FSB for the opportunity to participate in this public consultation process on “Financial resources to support CCP resolution and the treatment of CCP equity in resolution”, dated 15 November 2018.

BME CLEARING is a member of the European Association of CCP Clearing Houses (EACH), which has also produced a response to the FSB consultation paper. BME CLEARING agrees with EACH document and this individual response intends to highlight BME CLEARING’s points of view on certain topics.

It is important to make several preliminary considerations before responding to the consultation paper questions:

- CCPs are intrinsically different from credit institutions and financial services companies and have a different rationale and risk profile. For this reason, the regulatory framework for resolution should not completely mirror the banking resolution approach. It should focus on the achievement of the particular aims entrusted to CCPs as risk mitigation financial market infrastructures for the contribution to financial stability.

- Such contribution to financial stability, by means of reducing counterparty risk, is supported by the robust and resilient risk management requirements to which CCPs are subject under their regulatory regimes and under the CPMI-IOSCO Principles for Financial Market infrastructures. The risk management and default management frameworks, from a regulatory, legal and operational perspective, have been designed in a manner that permits CCPs to develop their activities with safety and robustness. This sound framework is supervised on an on-going basis, which makes even less plausible a resolution situation.
- CCP's risk and default management procedures, broadly incorporated in the internal rules and regulations of the CCP, have their main pillars in sound risk management (duly regulated and supervised by authorities), the collateralisation of all risks and the eventual mutualization of losses to contain them within the CCP. The whole system represents a comprehensive incentives scheme for clearing members to participate in the recovery measures to be adopted by the CCP in a financial stress event, that in most circumstances should be enough to address the situation and to permit the on-going functioning of the CCP in a safe and sound manner. This pushes the probability of a lack of resources very far and permits to discard the need of public funding. For that reason, resolution authorities should not step in to adopt resolution measures and to use resolution tools but after all the recovery measures of the CCP are exhausted.
- It is essential to consider the degree of criticality of the CCP in order to adapt the resolution treatment accordingly, in terms of adequacy and proportionality of the design and enforcement of the resolution regime: CCPs differ significantly in terms of the products they clear and their different sizes and risk volumes managed. The expectable self-containment of losses in a CCP and the very low probability of needing public funds could only pose certain doubts in the case of emergence of CCPs of such a big size that (in the unlikely event of a stress they can't handle) they reach a level of systemic risk unmanageable without a coordinated public intervention in resolution.
- The general principle of loss absorption up to the limit of the equity should be respected, as, in most cases, CCPs are limited liability companies.

II. SECTION I. FINANCIAL RESOURCES FOR CCP RESOLUTION

Q1. Do you agree with the suggested five-step process to evaluate the financial resources and tools for resolution? What other elements, if any, should be considered?

BME CLEARING agrees with the suggested five-step approach to evaluate the financial resources and tools for resolution.

In any case, we would like to point out several items in the answers below.

Q2. The discussion paper outlines a number of CCP and product specific factors that authorities should consider when assessing the adequacy of resources and tools in resolution. Are these factors appropriate or are there other factors that should be considered?

BME CLEARING believes that the CCP and product specific factors identified by the discussion paper are appropriate.

The degree of criticality and size of the CCP (in terms of risk exposure) are also of utmost importance for the correct assessment of the resources and tools in resolution, as well as for the definition of the resolution plan and the application of resolution tools adequately and proportionally.

Q3. Should the assessment of financial resources for CCP resolution take into account (a) different CCP ownership structures; (b) different CCP organisational structures; or (c) the products cleared by the CCP? If so, how?

BME CLEARING, as part of BME Group, considers that ownership structure and organizational structures do not necessarily have to be taken into account for the assessment of financial resources for CCP resolution.

In Spain, Bolsas y Mercados Españoles (BME) integrates the companies that operate and manage the securities markets and financial systems in Spain. BME brings together the Spanish equity, fixed-income and derivatives markets and their clearing and settlement systems.

We believe that there is a contagion risk, particularly in those cases where the CCP belongs to a group where other independent entities provide other critical financial services, like in Spain. For this reason, CCP resolvability should be assessed in a standalone basis.

The possibility of requiring parent companies contractually agreed guarantees, as a source of additional financial resources for the resolution of the CCP, would hinder the main purpose to avoid contagion. Moreover, this requirement could digress the general mercantile principle of limitation of liability to equity.

The more robust and sound the risk management framework of CCP is, the more unlikely the resolution situation becomes.

We would like to recall one of the preliminary remarks that we pointed out before: it is essential to take into consideration the products cleared by the CCP and the risk linked to these. Size and volume of the operations of the CCP, in terms of risk exposure, are essential factors too.

Q4. Step 1: The discussion paper outlines a number of high-level default and non-default loss scenarios that might lead to resolution. Does this cover a sufficiently broad range of scenarios? What other relevant scenarios, if any, should authorities consider in resolution planning?

Resolution should only be considered after recovery tools of the CCP have been exhausted. Therefore, default and non-default loss scenarios hypothetically leading to resolution must be coherently assessed and established accordingly and consistently with those anticipated in the recovery plan of the CCP.

The description of the scenarios included in the discussion paper seems complete. However, BME CLEARING would like to add the following remarks.

In CCPs risk management scheme, the margins to be required to participants (initial margins, default fund contributions, extraordinary margin calls) are defined and required to cover and address adequately the risk stemming from the products cleared by the CCPs. Besides that, CCPs have recovery plans in order to allow for the orderly recovery of the CCP and its critical services in an event of market stress. From our point of view, scenarios (i) for both default losses and non-default losses are not plausible as they imply non-compliance with CPMI-IOSCO standards and CCPs national legal regimes. It is necessary to bear in mind that in most of the jurisdictions the oversight approach is an on-going and complete supervision by CCPs supervisory authorities.

With regards to the scenarios (scenario (ii)) based on legal unenforceability of loss allocation arrangements, it would be worth noting the possibility for regulatory authorities to propose specific regulatory initiatives in order to ensure legal protection for such arrangements, where necessary, so that this scenario becomes not plausible.

In line with the general comment outlined above, resolution of the CCP should only occur after the exhaustion of recovery tools. For that reason, the scenario (iv) both for default losses and non-default losses, although theoretically possible, should be avoided.

We insist that applying the full recovery plan must be a priority in order to preserve the incentives scheme for clearing members. This would contribute to the continuity of the critical services provided by the CCP and would result in greater financial stability (e.g. to avoid a contagion effect across multiple CCPs).

Q5. Step 2: Are the considerations for conducting an evaluation of existing tools and resources appropriate and comprehensive? If not, what other considerations should be included?

We believe that the considerations for conducting the evaluation of existing tools are appropriate and comprehensive. The diversity and flexibility of the tools to be used by authorities in order to ensure an effective resolution phase is welcome.

As far as default losses are concerned, it is critical that no resolution tools in general, equity write-downs in particular, be permitted until a CCP exhausts all available recovery tools and clearing members meet all of their obligations to participate in the recovery measures. Besides, and as further explained later in this document, resolution tools should be considered with regards to

the CCP as an isolated entity, with no recourse to parent or affiliate entities' financial resources or guarantees, in order to avoid risk of contagion, especially where other critical services are provided by different companies in the same group.

Preserving the incentives to support recovery of the CCP is of the utmost importance, as highlighted by the FSB when analyzing the considerations for conducting an evaluation of tools and resources for resolution.

In our view, loss allocation for non-default losses should be proportional to the level of responsibility, risk and/or benefits derived from the service for each stakeholder, including not only the CCP, but also clearing members and other CCP users, in its case.

In particular, potential losses arising from investment risks could even be borne exclusively by participants when, according to the CCP rules and regulations, they are granted the decision of the investment and the benefits obtained with such investment, as is the case of BME CLEARING.

This principle of responsibility of NDL between CCP and its participants should be mirrored in the resolution planning by authorities.

Q6. Step 3: Are the considerations for analysing the hypothetical resolution costs (covering total losses and operational costs) appropriate?

Yes.

Q7. Step 4: Is there merit in relevant authorities and CMGs conducting quantitative analyses for the purpose of identifying and sizing potential additional tools or resources for resolution purposes? If so, what quantitative analysis should relevant authorities and CMGs conduct and how could they obtain the necessary data?

Strong coordination between resolution authorities, as well as with supervisory authorities when they are not the same, should be ensured.

Quantitative analysis should be based on realistic assumptions in order to correctly size the potential additional resources.

Q8. Step 5: Are the considerations regarding potential means to address funding gaps (including of any proposals to reserve resources for use in resolution) appropriate? Do they adequately address the issues of availability, costs and benefits, impact on and interaction with recovery and business as usual? If not, how should they be framed?

BME CLEARING believes that the considerations regarding potential means to address funding gaps are appropriately identified, though some remarks would be necessary in this respect.

Initial margin posted by non-defaulting participants should in no case be considered within the scope of the bail-in or write down powers of resolution authorities, whether legally bankruptcy remote or not. Initial margins are (even at legal level in a good number of jurisdictions) exclusively aimed at covering the risk deriving from the cleared products and are not part of the own

resources of the CCP available for resolution, regardless of the way of posting. They can only be used to cover the losses resulting from the closing-out of the position of the defaulting participants. The legal protection of the margin posted in favor of CCPs and the legal consideration of such margin as bankruptcy remote has been the successful result of a deep and thought legal analysis and legislative work in different jurisdictions. The fact that those margins could be protected for the event of insolvency of the clearing member and the CCP but, instead, be available for the resolution authority as a tool for the resolution of a CCP, would represent an essential contradiction. Legal certainty is of the utmost importance, the availability of initial margin for the resolution authority would jeopardize and put at risk the current legal certainty that benefits all the participants in the clearing ecosystem. It is worth noting further that the legal protection of the margins as bankruptcy remote permits financial services firms to apply better rates of capital requirements with regards to their exposures to CCPs. Modifying the current legal framework in this respect would also have a negative impact in the field of requirements for clearing participants.

The requirement of additional financial resources for resolution, under any figure, including a resolution fund, as further explained under the following sections, would oblige the CCP to reconsider their business models and would provide disincentives to central clearing.

Reserving some of the financial resources or tools for resolution would put at risk the recovery plan as a preferred action for the on-going functioning of the CCP and the incentive scheme for CCP participants to participate in recovery. The adoption of such a measure does not look adequate.

Finally, additional tools or resources for resolution, if any, should be set out and prescribed by law or statute or other administrative or regulatory decision or act. CCP Rule books are not the appropriate instrument to be used by authorities to implement and execute public resolution powers. Relevant authorities should have powers to authorize CCP internal rules and regulations or to suspend their application when any provision is in breach of the mandatory regulatory framework and, consequently to require their amendment adequately. Power to effect rulebook changes is not desirable.

III. SECTION II. TREATMENT OF CCP EQUITY IN RESOLUTION

Q9. Do you agree that the key issues to CCP equity bearing loss in resolution have been accurately identified? Are there other key issues regarding equity bearing loss? What are they and how should they be addressed?

In general terms, BME CLEARING agrees that the core issues related to the treatment of CCP equity in resolution have been acknowledged. However, in our view it is important to clarify several points.

Firstly, as noted earlier, it is essential to take into account that CCPs are risk managers, i.e., as opposed to banks, CCPs do not take risks themselves: CCPs are systems aimed at managing and mutualizing risks.

We see with concern the possibility of granting inadequate compensations, which would result in the breach of the incentives scheme in the recovery and resolution phases. CCPs have an incentive structure which ensures that all clearing participants are committed to contribute to the continuity of the CCP avoiding resolution. Any type of compensation in the resolution phase would harm such incentive scheme: the fact that clearing participants might have the opportunity to be compensated during resolution could prevent them from participating in the regular default waterfall process or in the use of the recovery tools contained in the CCP recovery plan.

It is also necessary to clarify that, in the event that the CCP recovers any amount, CCPs models usually prescribe a procedure to repay the contributions made by the members: the refund shall be distributed on a pro rata basis with respect to the amounts contributed and it must be distributed in accordance with a certain order. BME CLEARING rulebook includes a specific provision in that regard.

Lastly, according to the current CCPs business model, CCPs equity should not be taken as the basis in a resolution situation so as to deal with the risk brought by its members. CCPs equity roughly accounts for approximately 1% of the CCPs Initial Margins and 10% of the Default Fund (these are very rough averages). CCPs operators are far from being big companies such as other financial institutions and imposing additional financial resource obligations on CCPs could have negative effects on the clearing ecosystem. Having to prefund a greater amount of capital would lead to the need to change the business model by dramatically increasing clearing fees (to provide a reasonable ROE), which in the end could result in a disincentive to clearing, where clearing is optional. CCPs own contributions, SITG, as they are currently sized, are enough to complete the incentives scheme.

Q10. Should the treatment of CCP equity in resolution take into account different ownership structures? If so, how?

As previously mentioned, CCPs in resolution should be considered on a stand-alone basis. The possible impact that the CCP resolution could have in the other companies of its corporate group and the unwanted contagion effect must be taken into account.

Moreover, the fact that a CCP belongs to a corporate group should not involve supplementary requirements.

Q11. What are your views on the possible mechanisms for adjusting the exposure of CCP equity in bearing loss in resolution set out in Section A? What other possible mechanisms, if any, should be explored?

In our view, the mechanisms proposed in the consultation paper are reasonable.

We agree that equity should not be excluded from absorbing losses: loss absorption by equity should be part of the waterfall and resolution authorities should count on it. Moreover, CCPs risk management system places CCP equity at stake in the event of losses, firstly through the SITG and afterwards through standard mercantile laws that provide for equity to be first in line to absorb losses.

In any case, in our view, the regime should not go beyond the principle of limited liability.

Q12. Section B outlines different options for the point in time or in the waterfall for imposing losses on equity. What are your views on these options? Are there any other possible options?

We believe that it is essential to achieve the proper balance between a certain degree of flexibility for the resolution authorities and certainty for participants.

As previously mentioned, the incentives scheme of the CCP must be preserved and therefore, the default waterfall and all the recovery tools should be exhausted prior to the resolution authority's intervention. This would reduce the likelihood of claims according to NCWO. In that respect, option (iii) would be preferred, and within (iii), option (ii) is better, that is, at the end of the default waterfall, according to usual CCP regulations.

It is also worth mentioning that for European CCPs, EMIR includes a regulatory capital requirement in order to ensure that they would be able to organize an orderly winding down or restructuring of their activities. To that end, CCPs should hold sufficient financial resources to provide for operational expenses over a certain period of time. If the Resolution Authority is in charge of the winding down, the minimum regulatory capital allocated precisely for that purpose should be reserved to permit the winding down.

Q13. What are your views on the potential constraints and challenges described in Section C? Are there other challenges or constraints to equity bearing loss? What are they and how should they be addressed?

Bankruptcy and insolvency national laws must be fully in line with the CCPs resolution regime in order to achieve legal certainty.

The potential constraints and challenges are well explained in the consultation paper. If resolution authorities allow for the completion of the recovery phase and do not impose losses on equity or creditors too early in the process there should not be any difficulty.

In general, law systems subordinate shareholders to other creditors, even for CCPs that are not banks.

Q14. Section D outlines a number of policy considerations for the treatment of CCP equity in resolution. Are they appropriate and comprehensive? Would you suggest any additional policy considerations?

As far as we are concerned, shareholders equity is exposed to default loss. If there is any situation or jurisdiction where this is not always the case, the regulator should act in order to create the proper incentives for management. If participants choose fewer CCPs is probably because they see the benefits of concentrating outweigh the risks, and they are willing to co-operate in the risk management of the CCP by mutualizing risks.

Q15. Does the treatment of CCP equity in resolution appear clear under existing arrangements in your jurisdiction or in relation to CCPs you are familiar with?

Yes, the regime is clear in the Spanish jurisdiction, although the European framework is being discussed currently by the European institutions. As you are aware of, there is a proposal of Regulation of the European Commission, published in November 2016, a Report of the European Parliament, published in January 2018 and a compromise text of the European Council, of December 2017. Spanish law is pending on the approval of the European regime.

Q16. How could authorities reconcile the expectations that equity bears loss in resolution with the ‘no creditor worse off than liquidation’ safeguard?

We believe that the NCWO safeguard and expectations on equity bearing losses will be reconciled as long as authorities don't impose losses on equity or creditors too early in the process and respect the incentive scheme of the CCPs exhausting the recovery tools.

Q17. What, if anything, should change with respect to the treatment of CCP equity in resolution either to clarify existing arrangements or to potentially adjust the exposure of equity bearing loss in resolution (for example, setting out any additional measures to have equity bear loss in resolution in CCP rulebooks)?

BME CLEARING believes that it would be necessary to set out additional measures to have equity bear loss in resolution in those jurisdictions where it is not clear yet.