

CNMV ADVISORY COMMITTEE RESPONSE TO THE FSB CONSULTATIVE DOCUMENTS: FINANCIAL RESOURCES TO SUPPORT CCP RESOLUTION AND THE TREATMENT OF CCP EQUITY IN RESOLUTION

The CNMV's Advisory Committee has been set by the Spanish Securities Market Law as the consultative body of the CNMV. This Committee is composed by market participants (members of secondary markets, issuers, retail investors, intermediaries, the collective investment industry, etc) and its opinions are independent from those of the CNMV.

INTRODUCTION

The Spanish CNMV Advisory Committee welcomes the FSB public consultation on “Financial resources to support CCP resolution and the treatment of CCP equity in resolution”, dated 15 November 2018, issued in the context of the FSB commitment to continue further work on CCP recovery and resolution, in order to help inform the development of further guidance by the end of 2020, and which aims at contributing to the identification of the main considerations that should be relevant for authorities and crisis management groups with regards to:

- evaluating whether existing financial resources and tools are adequate to implement the resolution strategy for individual CCPs
- treatment of CCP equity in resolution

Prior to responding to the questionnaire included in the consultation paper, the CNMV Advisory Committee would like to highlight the following important remarks:

- CCPs are conceived as entities with a nature, purpose and risk profile essentially different from credit institutions and financial services companies. These essential differences between CCPs and financial services firms justify the application of a different regulatory framework for resolution which does not need to completely mirror the banking resolution approach but, instead, it does need to pursue 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 based on 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.
- 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 ongoing 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.

- Given the wide variety of products cleared by CCP and their different sizes and risk volumes managed, the resolution authorities should weigh the degree of criticality of the CCP in order to adapt the resolution treatment accordingly, in terms of adequacy and proportionality of the resolution plan and of the application of the resolution tools. 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.
- Being the CCPs, in most cases, limited liability companies the general principle of loss absorption up to the limit of the equity should be respected.

Please find below the answers given by the CNMV Advisory Committee to the questions raised in the public consultation.

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?

The CNMV Advisory Committee believes that the five-step approach proposed by the FSB to evaluate the financial resources and tools for resolution is appropriate.

In the answers below some detailed comments on particular items are outlined.

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?

The CNMV Advisory Committee believes that CCP and product specific factors must be considered by authorities. The factors identified by the discussion paper are appropriate.

Together with those factors, as mentioned above, the degree of criticality and size of the CCP (in terms of risk exposure) are essential and must also be taken into account 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?

The CNMV Advisory Committee 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 order to avoid risk contagion, particularly in those cases where the CCP belongs to a group where other independent entities provide other critical financial services, CCP resolvability should be assessed in a standalone basis. For CCPs belonging to a larger group, considering 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 risk contagion. Besides, this requirement of an additional guarantee on top of the equity of the CCP, would depart from 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.

To ensure a proportional and robust approach to resolution the assessment should 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 must be considered as a last resort scenario for those events where the recovery tools of the CCP have been exhausted. CCP will apply their recovery tools in accordance with their respective recovery plans, which must have already identified the corresponding hypothetical default and non-default loss scenarios. Default and non-default loss scenarios hypothetically leading to resolution should be coherent with those anticipated in the recovery plan of the CCP.

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

CCP risk management tools, including 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 CCP. In addition, CCPs have implemented a comprehensive set of recovery tools that permit the orderly recovery of the CCP and its critical services in an event of market stress. Full compliance of these risk management and recovery requirements imposed to CCPs is subject to on-going supervision by CCPs supervisory authorities. Scenarios which imply non-fulfilment, not only of CPMI-IOSCO standards but also with mandatory legal regimes applicable to CCPs, in this context of on-going and complete supervision, are not seen as plausible (scenario (i)) for both default losses and non-default losses).

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.

The possibility of applying the full recovery plan must be a priority. Preservation of the incentives scheme for clearing members to participate in the recovery process is crucial for the protection 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?

A wide and flexible range of tools to be used by authorities in order to ensure an effective resolution phase is welcome.

With regards to default losses, 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 contagion. This remark becomes extremely important in the cases 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.

Non-Default losses (NDL) do not necessarily and automatically have to be allocated to the CCP. On the contrary, 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.

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?

The CNMV Advisory Committee considers that the issues raised for analysing the hypothetical resolution costs are correct.

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?

The CNMV Advisory Committee believes that the considerations regarding potential means to address funding gaps are appropriately identified. 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 requirement of additional financial resources for resolution, 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.

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, the CNMV Advisory Committee 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.

As previously mentioned, it is of utmost importance to bear in mind that, as opposed to banks, CCPs do not take risks themselves: CCPs are systems aimed at managing and mutualizing risks.

The CNMV Advisory Committee sees with concern the possibility of misplacing incentives in the recovery and resolution phases by granting inadequate compensations. 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.

Lastly, it is worth to point out that 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?

CCPs in resolution should be considered as independent entities. The fact that a CCP belongs to a corporate group should not involve supplementary requirements.

If anything, as previously mentioned, it is important to take into consideration the possible impact that the CCP resolution could have in the other companies of its corporate group and the unwanted contagion effect. For this reason, CCPs should be assessed on a singular basis.

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?

The CNMV Advisory Committee considers that the mechanisms proposed are reasonable.

It is clear that CCPs risk management system places CCP equity at stake in the event of losses: firstly through the SITG, and afterwards through standard mercantile legislation that provides for equity to be first in line to absorb losses.

Therefore, we agree that equity should not be excluded from absorbing losses and that is not the case in the instances we are familiar with. Loss absorption by equity should be part of the waterfall and resolution authorities should count on it.

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?

There is a need for some degree of flexibility for the resolution authorities and certainty for participants, but it is necessary to take into account the impact on the incentive model of CCP achieved with its default waterfall system.

As previously mentioned, it is key to protect the incentives scheme of the CCP and consequently, 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 European CCPs have a regulatory capital requirement in order to ensure that they would be able to organize an orderly winding down or restructuring of their activities, 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?

The CNMV Advisory Committee fully agrees that legal certainty is essential and therefore bankruptcy and insolvency national laws must be perfectly aligned with the regime of CCPs resolution.

The potential constraints and challenges are well explained. As long as resolution does not impose losses on equity or creditors too early in the process (without exhausting the recovery phase) there should not be any challenge.

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?

We do not know of cases where shareholders equity is not exposed to default loss, but if there is any case, the regulator should act in order to create the proper incentives for management. If participants choose fewer CCPs is because they want to, because they think 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 our 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?

As stated above, in order to keep the incentive scheme of the CCPs, it is essential to exhaust the recovery tools. If authorities respect that point and they don't impose losses on equity or creditors too early in the process, NCWO safeguard and expectations on equity bearing losses will be reconciled.

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)?

The CNMV Advisory Committee believes that it would be necessary to set out additional measures to have equity bear losses in resolution in those jurisdictions where it is not clear yet.