

clear to trade



**Eurex Clearing  
Response  
to the**

**FSB Discussion Paper for  
public consultation on**

“Financial Resources to support CCP  
resolution and the treatment of CCP equity in  
resolution”

February 2019

## A. Introduction

Eurex Clearing is a globally leading central counterparty clearinghouse (CCP). Eurex Clearing is a subsidiary of Deutsche Börse Group providing central clearing services for cash and derivatives markets both for listed as well as certain over-the-counter (OTC) financial instruments. Eurex Clearing actively contributes to market safety and integrity with state-of-the-art market infrastructure both in trading and clearing services as well as with industry leading risk management services for the derivatives industry. Customers benefit from a high-quality, cost-efficient and comprehensive trading and clearing value chain.

Eurex Clearing AG is an EMIR authorized CCP incorporated in Germany. Eurex Clearing is also licensed as a credit institution under supervision of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) pursuant to the Banking Act (Gesetz für das Kreditwesen). US Commodity Futures Trading Commission has (CFTC) granted Eurex Clearing AG Registration as a Derivatives Clearing Organization.

Eurex Clearing welcomes the chance to comment on the latest consultation from the FSB as part of the ongoing work it and other international standard setting bodies continue on key financial stability and market integrity topics.

As a general remark, we would like to highlight that in our view, the key features of the latest consultation, and the future work it outlines for the SSBs, competent authorities and CCPs, is primarily a fine tuning of the cornerstones laid down in the original FSB Key Attributes and CPSS-IOSCO PFMI, and the specifications for CCPs in the FMI Annex and the corresponding CPMI-IOSCO recovery report. In particular, we consider that these, and their jurisdictional implementation in our case, have suitably structured the risk management and incentive structure of centrally cleared markets. We appreciate the importance of ensuring that moral hazard does not arise in CCP markets, and welcome consultations and conversations which investigate or seeks to mitigate it where perceived. However, we would highlight that if the possible issue of concern, as outlined (on page 18) in the consultation, is that CCP shareholders are to an unintended extent shielded from losses in resolution, then this can and should be rectified through resolution authorities having the appropriate measures as outlined in the original Key Attributes. This bears repeating, since certain aspects of the consultation appear to stray from this perceived problem to discuss proposals which do not address this point, but would be highly disruptive for the overall risk management framework of CCPs and have the effect of making CCP underwrite, or claiming to underwrite, the recovery tools (on page 22).

## B. On Specific questions raised

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?

- We welcome the approach to define a clear and transparent process evaluating adequacy of financial resources in resolution. The proposal is the most logical structure to do so. In particular the element to identify potential gaps upfront will be beneficial to financial resilience (for more detailed considerations regarding the different steps questions Q4 to Q8).
- We believe what it is generally important when defining such a process is to keep sufficient flexibility in order to ensure that no relevant factors will be excluded from the assessment due to an overly stringent process. Also the process should be adaptable to evolving circumstances and the results of the process should always be considered against the impact on the incentive structure in the CCP system as a whole.

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?

- We fully agree that the factors outlined are relevant to assess the risk structure realistically and as such those are factors that are relevant for resolution planning.
- The listed factors are not only relevant for resolution planning but are points that are also relevant for the daily risk management and respective margin levels.
- From our perspective the prevailing point of resolution planning is always to consider the impact of the resolution strategy on the overall incentive structure across all levels of safety measures from default management, recovery planning to resolution planning. Creating wrong benefits in resolution for individual stakeholders would create a false incentive with a destabilizing effect on the system as a whole. This could apply either in the form an ongoing pressure during business as usual by CCP stakeholders to limit their liabilities, or in-crisis game theory to behave in a system-wide sub-optimal manner.
- The key element which is specific to different CCPs which we believe is relevant for such considerations is the form of recovery tools the CCPs is likely to use, where design choices exist even for a particular “type” of CCP as determined by the factors listed in the consultation. In particular, it is important to consider whether the CCP’s rulebook changes the surviving participants’ trades’ economics directly or indirectly (VMGH and cash calls respectively), or the removes contracts which could not be rebalanced (PTU, allocation), or both, and in what order.

- While we recognise that the examples of the specificities or idiosyncrasies are only illustrative, we would nonetheless for the sake of precision make certain remarks (to the bullets on beginning on page 4);
  - We wonder whether reputational damage to the particular CCP operator itself matters in *resolution* scenarios which ensnare its entire business spectrum, since we assume the CCP operator is replaced. The reputation of the market place, and the participants, who for one reason or another are the key actors in a market that could not be rebalanced, may however be great.
  - We agree that inability to identify end-clients, or the way in which direct members may or may not pass recovery tool impact onwards complicates the ability of resolution authorities to determine the effect of the broader financial system.
  - We would highlight that derivative CCPs may have products, such as premium style options, for which mark-to-market margins are not symmetrical and are not paid out to the winners until conclusion of the trade. Furthermore, not all CCPs and their participants have chosen to implement VMGH for variation-style derivatives, and we would contest the description that presumes it to always be included in the toolkit. Certain CCPs may prefer cash calls coupled with (partial) tear-ups as comprehensive tools.
  - While we agree that multi-service CCPs require greater scrutiny, the point on collateral concentration is in our view not exclusive to them. Indeed, a simpler, more local CCP may have much greater concentration of members, or a narrower collateral acceptance schedule, which can create greater relative effects.
  - For interoperable CCPs, potential gaps in resources in resolution can only be ascertained if the linked CCP is also assumed to default. Stakeholders of interoperating CCPs should carefully consider what recovery and resolution measures can be applied to the surviving CCP's members should one or more linked CCPs fail.

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

- As ownership structures diverge significantly across CCPs, it appears sounder to assess the resolvability of the CCP on a standalone basis. In our view, the proposed EU CCP recovery and resolution legislation adopted a clever approach: the CCP as a regulated entity should be able, in isolation, to address any recovery and resolution requirements. Where authorities consider them sufficiently robust, support from parent or group companies can be considered. This approach enables authorities to ensure CCP financial resources are addressable regardless of ownership

structure, but have the flexibility to permit particular solutions, provided they satisfy authorities’ stipulations.

- Where the CCP is part of a larger group, Resolution Authorities should duly consider the impact of the resolution of the CCP may have on other legal entities within the group, especially if they provide other critical services to avoid contagion in a crisis scenario.
- In order to assess the availability of additional financial resources for the resolution of the CCP, Resolution Authorities should ensure that contractually agreed arrangements, such as parental guarantees, can be appropriately enforced.

**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?

- We highly appreciate the clear distinction of relevant scenarios between default and non-default loss scenarios. We believe the list of scenarios should not be considered complete as it can never be known how a situation will develop into a resolution scenario exactly. We consider that a CCP’s risk management framework, including its recovery options, should be sufficiently strong and comprehensive –as required by CPMI/IOSCO-FSB guidance- to address all but the most esoteric or truly force majeure (e.g. regulatory imposition) scenarios. As such, we think of such scenario analysis as a challenge to the existing scenario set, or an approach to determine how to react to unforeseen scenarios. It may well be that certain scenarios only arise in situations when continuity of even key functions of some markets is not desirable or credible, and these should not be covered.
- We would like to emphasize a few noteworthy points regarding the individual scenarios:
  - On scenario i) from an EU perspective this scenario appears rather unlikely as EU CCPs are closely supervised to fulfill EMIR requirements and thus compliance with CPMI-IOSCO standards.
  - On scenario ii) the description of this scenario demonstrates clearly the importance of flexibility. Should a strict execution of the recovery plan leads to greater losses than to directly trigger resolution, this should be possible.
  - On scenario iii) this scenario shows the importance of aligned incentives for all stakeholders to support and benefit from a successful recovery and/or resolution.
  - On scenario iv) we fully agree that the relevant authorities should have the power to trigger resolution where the situation is evident for this action to create the more positive outcome regarding overall financial stability.

- Having said that, we consider that the list provided in the consultation is sufficiently broad to cover virtually all scenarios. We would however have three further scenarios to propose, although they are in our view captured by the framework:
  - There is always a possibility that resolution proceedings are opened simply because of a management failure at a CCP, for instance if the CCP operator does not, for whatever reason, action the recovery tools available to them.
  - There is furthermore the possibility that political or regulatory sanctions, for instance the forced cessation of clearing services in certain products or for certain clients creates a scenario which cannot be covered by the traditional resilience or recovery measures.
  - Finally, we would stress that direct or indirect participants may strategically choose the fail towards a CCP (“walk away” scenario). This could be due to pressures in a severe crisis to focus on continuity at only key FMIs, or to compel public sector intervention. We consider this scenario worth highlighting, so as to remain vigilant against changes in incentive or market structure which could increase its likelihood.
- We fully agree with the outlined non-default loss scenarios describing possible ways into resolution due to a non-default loss. We want to emphasize our understanding that non-default handling should be separated from default handling.
- We further appreciate the view that non-default losses due to general business risk should be borne by the CCP only and losses where under normal circumstances the clearing members benefit from the services provided by the CCP (e.g. investment risks), loss allocation should follow a fair allocation logic.

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 the listed considerations include the most important points for the evaluation of resolution tools. We consider the impact of a tool on the incentive structure as most important.
- The list of most important resources and tools contains relevant ones from our perspective. In this context it appears important to emphasize the importance of flexibility in the application and possible combination of the listed tools. A flexible approach will ensure the best possible reaction to a given situation in the interest of financial stability.
- The original Key Attributes are quite clear that NCWO does not imply *pari passu*. While we agree that an unjustified or unequal allocation of losses may well be contested, we observe that CCP waterfall best practice is to

distinguish behavior amongst members to determine loss allocation (e.g. non-bidding in mandatory auctions leading to juniorisation). This distinction should be fair, and in place to increase positive behavior or minimize the probably of game theoretic pressures, especially given the possibility for collective-action problems or free-rider effects to arise.

- For specific comments;
  - We would repeat our point that not all derivatives have symmetric and paid out variation margin prior to conclusion of the trade, and that even for derivative markets with paid out variation margin, not all CCPs and their market participants have elected to use VMGH.

We would mention that “buy-in” can be used as the terminology for certain types or matched book tools.

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

- We agree with the outlined wide approach to defining resolution costs, and that the listed points are suitable to estimating the costs of resolution. The key concern for authorities, and the market generally, is to have an evaluation of the possible costs of a wind-down and liquidation/insolvency, so as to be able to estimate if NCWO is relevant. This requires considering what market participants, as well as the CCP operator, would suffer as consequences if following recovery and wind-down tools, the CCP was closed down through insolvency.

**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?

- In addition to our response to Q4 four, we would add the following. We generally agree with the approach to conduct a gap analysis in order to identify any shortfalls ex-ante. We would stress that authorities should check, during any evaluation, whether the scenarios which cannot be covered are ones where resolution is necessary or desired. For instance, if the market has become unviable with no interest from its former participants to continue, then re-establishing the CCP is not necessary, and this scenario should be earmarked as such prior to considering necessary resourcing.

**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?

- Against the background of points outlined regarding Q7, we agree that it should be clear and transparent what measures the resolution authority should be able to take in case of an identified gap.
- We particularly appreciate the considerations as regards the impact of any measures on the incentive structure of the CCP system as a whole, potential disincentive to clear and the cost of clearing.
- We believe that carving out prefunded resources for resolution will not prove ideal for all scenarios – e.g. where the extra resources could reestablish a matched book in recovery without having to trigger resolution, it appears more logical to use the extra funds in the recovery phase avoiding higher costs.
- We strongly oppose to introduce the option of what is termed a bail-in power in this consultation as it breaks the loss mutualisation principle the CCP is based on, shifts the cost of covering tail risks to the operator only and as such creates an inequitable loss distribution. Thus the introduction of bail in would significantly impair the incentive structure of the CCP. We consider that a CCP operator should accept that for DMP losses, the CCP is lose-only (SITG and other resources) and lose-all (Resolution Authority take-over or insolvency). This is extremely strong and incentive structure for the operator. The contributions of the operator are and should be marginal compared to the loss mutualisation of the participants, and we disagree that there should be a shift away from market participant mutualisation of the tail. We do not consider that this is necessary, nor is there an issue with CCP operator incentives to be rectified in such a configuration.
- Finally, we would reiterate our comment from previous consultations that to the extent that certain cleared contracts have theoretically unlimited pay-offs, then a market that insists on limited cash calls must, in a “comprehensive” loss allocation structure ultimately either modify these economics (e.g. VMGH), or terminate the positions (e.g. PTU).

#### **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?

- We believe the key issues to CCP equity bearing losses in resolution have been identified. The overarching point to also consider is the impact of any decision on the well functioning of the CCP incentive structure.
- The NCWO principle is an important tool to ensure that markets are not continued beyond a point of unviability by authorities with great powers. We do not, however, agree that NCWO should provide a mechanism for the mutualisation and private loss bearing inherent in CCPs to be minimised despite seeking continuity of the markets. This is in our view the most concerning source of moral hazard, and should it transpire, greatly restricts a CCP’s and good faith participants’ ability to resist a race to the bottom. As such, it is key for the NCWO-principle and in particular the

counterfactual to be well designed to effectively fulfill this purpose. In that context we believe the counterfactual should reflect the Value of Continuity of the CCP.

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

- We would simply note that based on the history of various events at CCPs, including mutually owned ones, mixed ownership ones, ones with effective state control, or private ones, we do not detect a pattern for any scheme having avoided disruptions that have exceeded “defaulter pays”. As such, it would appear that such events are either truly unforeseen situations which overwhelmed the old risk management paradigm, or that vigilance is required for any structure.
- Please also note our answer to Q3.

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 listed mechanics outlined in the consultation report include the most relevant ones.
- For the points outlined in the consultation report, we would like to point out the following:
  - We remain adamantly against proposals to “compensate” clearing members for cash calls, or other tools agreed to in the waterfall and recovery plan. “Compensating” clearing participants for loss distribution moves the CCP system away from a mutualisation structure that drives prudent behaviour and market discipline. Awarding money or shares from the CCP operator to “repay” any loss allocation switches the central clearing system from a zero-sum game in which participants accept higher risk management standards to protect themselves, to one in which they seek higher CCP capital instead. We consider this to dramatically affect the incentive structure and weakening it, and as such, oppose the proposal.
  - As an additional remark we would once again explain that any loss allocation, for instance a collected cash call, is not kept by the CCP, but paid out to other (winning) members. While Eurex Clearing does not employ VMGH as a recovery tool, any payment cropping tool has the same feature: the haircut is not kept by the CCP, and thus “repaying” it is a dramatic modification to the CCP system.
- Please also note our introductory remark on this point. We would also refer to our previous responses to FSB and CPMI/IOSCO consultations, in which we have expanded on our strongest disagreement with the trend to

modifying CCPs to firms which in substance underwrite tail or market risk with their own resources, as opposed to arrange a mutualisation system for market participants.

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 very much appreciate and agree that the impact of the use of equity in resolution on the CCP incentive structure has been put in the focus of the consideration. The consultation report includes most relevant perspectives.
- Against this background we want to mention our understanding that once resolution has been triggered, equity of the CCP can and will be depleted by the resolution authority. For clarification, the Resolution Authority may chose not to use equity to cover losses or costs, but could still have the ability to take over the CCP with the effect that current shareholders lose their stakes.

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?

- NCWO claims by shareholders are a natural consequence of the Key Attributes, to safeguard against a Resolution Authority randomly declaring a CCP “likely to fail” if there is absolutely no evidence for it. However, Resolution Authorities should protect themselves against spurious claims, and we do not consider it likely that a CCP that required resolution proceedings to commence is able to convince anyone it could have survived.
- The authorities and policy makers should fix the legislative and regulatory rules if they are concerned about this. We note that CCPs are only viable companies provided competent authorities provide them a license, and if their participants choose to use them.

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 appreciate the detailed considerations outlined as regards to the impact of the treatment of CCP equity from the different stakeholders’ perspectives, which is an important element to maintaining or improving the sound and well-functioning incentive structure of CCPs in resolution. We would however make the following remarks;
  - We do not think the issue is specific to privately owned CCPs. For mutually owned systemic CCPs, it is perfectly possible that its owners could also seek to maximize profitability either through

lower levels of risk management and investment, or by limiting their exposure (capped cash calls, smaller equity, tools designed to affect non-owner users or clients). Unless the FSB is indicating that mutually owned CCPs are excluded from the possibility of public intervention from resolution, we do not understand the distinction.

- Since a CCP ultimately depends on its participants to rebalance it, we wonder whether in the long term, a CCP that chooses to mitigate costs and members’ desire for an extremely low probability of mutualisation will prove to be a particularly robust system. In our view, this approach of substituting CCP capital for initial margin or default fund diminishes the link and interest of members in the CCP’s risk management ability, and as such decreases scrutiny and safety of the overall system.

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?

- The legislative process to creating an EU-wide harmonized framework for recovery & resolution of CCPs is underway, and has on balance developed positively. We are optimistic the new regulation will create a rule set which is clear on the treatment of equity in resolution.

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

- NCWO is a necessary and useful safeguard to protect clearing participants or the CCP operator from possible arbitrary decisions of Resolution Authorities.
- However, the NCWO should not be used as a means to tie the hands of public authorities which could be exposed to ex-post financial claims if the Resolution Authority had decided to use resolution tools beyond those contractually agreed between the CCP and the clearing participants.
- The NCWO principle should therefore reflect the full value of continued access to central clearing including the loss of participants’ positions and their replacement, increased capital requirements from unavailability of multi-lateral netting, loss of revenues from indirect clearing, and the negative impact on financial stability as a whole.
- The NCWO principle should not be based only on the rulebook of the CCP as this would create an ex-ante incentive for participants to weaken the rulebook and waterfall of the CCP.

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)?

We consider that existing work by the FSB-CPMI/IOSCO and key jurisdictions has already established the framework and, more often than not, clear rules either in private contract or law on this. While there may be individual cases that could merit attention, we do not see a need to revisit the FSB Key Attributes and related standards.

## C. Closing

We hope that you have found these comments useful and remain at your disposal for further discussion. In particular, should there be interest in the list of CCP disruptions referenced in our answer 10, we would be happy to provide details. If you have any questions please do not hesitate to contact:

## D. Contacts

Thomas Laux  
Chief Risk Officer  
Member of Eurex Clearing Executive Board  
Eurex Clearing AG

[Thomas.Laux@eurexclearing.com](mailto:Thomas.Laux@eurexclearing.com)

Teo Floor  
Vice President  
Clearing Strategy and Initiatives  
Eurex Clearing AG

[Teo.Floor@eurexclearing.com](mailto:Teo.Floor@eurexclearing.com)