

Financial Stability Board
fsb@fsb.org

19/10/2016

Dear Sir or Madam,

FSB Consultation: Essential Aspects of CCP Resolution Planning

LME Clear is a clearing house (CCP) incorporated in the United Kingdom and has been established to provide central counterparty clearing and settlement services for the London Metal Exchange (the LME). The LME is the most liquid industrial base metals market in the world. LME Clear is an authorised CCP for the purposes of the European Market Infrastructure Regulation (EMIR).

We welcome the opportunity to provide feedback to the discussion note on Essential Aspects of CCP Resolution Planning. We have attended a number of meetings with the Bank of England and representatives of the FSB (as well as other CCPs and market participants) on this topic in recent months. Our input to date has largely been through our membership of the European Association of CCP Clearing Houses (EACH). We therefore refer to and support EACH's response to the discussion note.

As a UK CCP, LME Clear has already adopted a recovery plan (supported by its rules) which is adapted to the market it clears. We are authorised to clear commodities (mainly in base metals as well as precious metals) on a variety of prompt dates with physical delivery.

Below we summarise our views on the questions which were posed in the discussion note. These reflect the views given by EACH. Please refer to the EACH response for more details.



Q1: Does this discussion note identify the relevant aspects of CCP resolution that are core to the design of effective resolution strategies? What other aspects, if any should authorities address?

We consider that the discussion note does identify the relevant aspects of CCP resolution that are core to the design of effective resolution strategies. We would like to stress the following points made in the EACH response:

- Importance of incentives – a CCP resolution regime must not negatively disrupt the incentive structure of a CCP. In particular the incentive to participate constructively in the recovery process must be maintained.
- Importance of restoring a matched book – this must underpin any successful CCP resolution regime.
- The fact that CCP resolution would only ever result from very extreme circumstances (indeed circumstances that went beyond the “extreme but plausible” standards for stress testing laid down by international standards).
- Global consistency – we welcome the efforts of the FSB to establish global standards but emphasise the importance of consistent application of such standards in order to achieve true consistency.

We would also encourage transparency between the resolution authority and each CCP during the design of the resolution plan. A CCP will be well positioned to understand the limitations of its recovery plans and rules (as well as the appetite of clearing members to absorb certain specific risks) and can assist the resolution authority in designing a resolution plan that can meaningfully supplement and complement the recovery phase and therefore maximise the chances of any resolution phase being successful. The same resolution plan would not be appropriate for all CCPs. A resolution plan needs to be tailored to individual CCPs.

Q2: What is the impact on incentives of the different aspects of resolution outlined in this note for CCP stakeholders to support recovery and resolution processes and participate in central clearing in general? Are there other potential effects that have not been considered?



It is important to ensure that non-defaulting clearing members actively participate throughout the default management process. We are concerned that compensating clearing members for participating in the resolution process could alter the existing incentive structure under the recovery process (particularly in relation to the auction).

Q3: What are the appropriate factors for determining timing of entry into resolution? How might a presumptive timing of entry (or range of timing), if any, be defined in light of the criteria set out in the FMI Annex to the Key Attributes? If defined, should the presumptive timing of entry be communicated to the CCP and its participants?

We believe that the time of entry to resolution should be defined by reference to unsuccessful (or objectively likely unsuccessful) implementation of the CCP's recovery process set out in its default management procedures. There should be no presumption that resolution of a CCP is required other than by reference to objective criteria determining that the recovery process has not been or will not be successful. Early intervention should be considered as a tool of last resort in all cases. Further, financial stability concerns should be the main driver behind any intervention.

As noted in the EACH response, if early intervention occurs, it is critical that the legal responsibility of either the CCP management or the resolution authority is clearly set out in relevant legislation at all times to avoid a situation whereby the CCP's management would find itself only partially independent but legally accountable for the decisions made.

Q4: Should CCPs be required to hold any additional pre-funded resources for resolution, or otherwise adopt measures to ensure that there are sufficient resources committed or reserved for resolution? If yes, what form should they take and how should they be funded?

Please refer to the list of current default resources set out in the EACH response. It is important to fully understand these before considering what further resources may be necessary. We believe that all resources should be available to a CCP as part of



the recovery phase. The ring-fencing of any resources for the resolution phase would inevitably decrease the likelihood that a CCP could remain viable as part of the recovery phase. We do not believe that this would be in the interests of financial stability.

The current skin in the game of CCPs under EMIR is designed to promote sound and prudent management which is ultimately the best incentive to avoid resolution or even recovery in the first place. Any additional layer would not be meaningful and would result in additional cost to clearing members and other participants. The additional cost may even deter membership and lead to CCPs with fewer clearing members.

Q5: How should the appropriate quantum of any additional CCP resources be determined? In sizing the appropriate quantum, what factors and considerations should be taken into account? Do your answers vary for default and non-default losses?

We refer to the EACH response.

Q6: Should resolution funds external to the CCP be relied upon? If so, how should such funding arrangements be structured so as to minimise the risk of moral hazard, including for CCPs with significant cross-border participation? Where these are pre-funded, how should the target size be determined and which entities should be required to contribute?

We believe that the cost and difficulty in securing and maintaining such funding would be disproportionate to the risk of confronting such a remote situation. We are also concerned that the existence of external resolution funds may distort the incentives present in a CCP's recovery process thereby increasing the chance that such funds would need to be used by their very existence.

Q7: What factors should the resolution authority consider in choosing and exercising tools to return the CCP to a matched book? Is one (or more) of the tools for restoring a matched book preferable over others and if so, why?



The starting assumption should be that a CCP will be given the opportunity to return to a matched book by exercising its recovery tools. If it can be demonstrated that a CCP has not been able or will not be able to achieve this then the resolution authority should not limit itself to a pre-defined subset of resolution tools.

The use of particular tools may be more appropriate in particular circumstances. However, we feel that certain tools are more likely to be more effective and less damaging to the market than others. It is important that the resolution authority identifies in advance, for each CCP, the relevant tools that could be used, taking into account the market(s) for which each CCP clears. For example, partial tear up may be an appropriate tool for resolution authorities to consider using where the CCP's recovery tools have not returned (or are unlikely to return) the CCP to a matched book. This is because it allows the isolation and elimination of a smaller, illiquid market segment while allowing the broader market to recover from the relevant stress event. In our view, partial tear up may be in respect of a specific type of instrument (i.e. a specific metal in LME Clear's case) or certain trades. However, it would be useful for greater clarity around what is generally meant by partial tear up when used by resolution authorities.

The resolution authority should also be able to change the order of tools and not be constrained by CCP rules in this respect.

Q8: Should any tools for restoring a matched book only be exercisable by resolution authorities? If so, which tools and subject to what conditions?

As noted above, we believe that all of the tools defined in the CCP's recovery plan (and therefore in its rules) should be exercisable by the CCP during the recovery phase.

Q9: What are in your view effective tools for allocating default and non-default losses and what are the pros and cons of these tools? Should initial margin haircutting be considered as a tool for the allocation of losses in resolution? Is one or more of the tools preferable over others? What are your views on the use of tools to restore a matched book as a means of loss allocation?



We refer to the list of tools set out in the EACH response. We would also like to highlight that, from a CCP risk management point of view; one of the major benefits of VMGH is that it acts as an incentive on the clearing members which assists the CCP in closing positions.

Q10: Which, if any, loss allocation tools should be reserved for use by the resolution authority (rather than for application by a CCP in recovery)?

As noted above, we believe that all of the tools defined in the CCP's recovery plan (and therefore in its rules) should be exercisable by the CCP during the recovery phase. An assumption that the resolution authority will not step in until a CCP's recovery plan is exhausted will help to ensure that clearing members do not alter their behaviour in the recovery phase and continue to participate constructively in a CCP's default management process.

Q11: How much flexibility regarding the allocation of losses is needed to enable resolution authorities to minimise risks to financial stability? For example, to what extent should a resolution authority be permitted to deviate from the principle of pari passu treatment of creditors within the same class, notably different clearing members in resolution? What would be the implications of a resolution strategy based primarily or solely on a fixed order of loss allocation in resolution set out in CCP rules vs. a resolution strategy that confers discretion to the resolution authority to allocate losses in resolution differently to CCP rules?

As noted above, we believe that all tools should be available to the CCP as part of the recovery phase. It therefore follows that the intervention of the resolution authority must involve the application of the tools in a different order than that available to the CCP in the recovery phase. An obvious example would be to allow a resolution authority to exercise a particular tool (for example partial tear-up) earlier in the waterfall than was originally intended under the CCP's recovery plan.

We believe that by using the tools prescribed in the CCP's rules and keeping the ability to apply such tools in a different order, a resolution authority would be able to minimise any risks to financial stability.



Q12: What are your views on the potential benefits or drawbacks of requiring CCPs to set out in their rules for both default and non-default losses: (i) The preferred approach of the resolution authority to allocating losses; (ii) An option for, or ways in which, the resolution authorities might vary the timing or order of application of the loss allocation tools set out in the rules?

As noted above, we believe that all of the tools defined in the CCP's recovery plan (and therefore in its rules) should be exercisable by the CCP during the recovery phase. Whether it is useful or necessary for such rules to contemplate their use by resolution authorities may depend to a large extent on the legal regime which applies in the relevant jurisdiction. Clearly a CCP's rules should not in any way inhibit the use of tools which a resolution authority would require in resolution.

It should be noted that non default losses (NDL) are very different from default losses and that they should have a separate recovery waterfall.

Q13: How should non-default losses be allocated in resolution, and should allocation of non-default losses be written into the rules of the CCP?

LME Clear includes a mechanism for the allocation of non-default losses in its rules already. Such mechanism includes a priority contribution from CCP capital followed by unfunded member contributions. The mechanism was put in place in accordance with existing UK legislation.

It is important not to be too prescriptive as to how non-default losses as a general class are covered as it may be sensible to use different mechanisms to deal with different non-default losses (investment counterparty losses, operational losses etc.) and each may have to be dealt with differently. For example, loss allocation may be proportional to the level of responsibility of each stakeholder involved for bringing risk into the CCP or defining the policies for mitigating such risks. For instance, it is important to remember that investments will be made in accordance with an investment policy which is approved by the Risk Committee (as well as within the parameters set down by EMIR).



Q14: Aside from loss allocation, are there other aspects in which resolution in nondefault scenarios should differ from member default scenarios?

We refer to the EACH response. The difference between default and non-default losses in a resolution scenario is the difference in tools available for loss allocation.

Q15: What is the appropriate NCWO counterfactual for a resolution scenario involving default losses? Is it the allocation of losses according to the CCP's rules and tear-up of all the contracts in the affected clearing service(s) or liquidation in insolvency at the time of entry into resolution, or another counterfactual? What assumptions, for example as to timing and pricing or the re-establishment of the CCP's matched book, will need to be made to determine the losses under the counterfactual?

The appropriate counterfactual is likely to be, as a matter of law, the application by the CCP of all of the recovery tools available under its rules (including tear up where relevant) followed by the liquidation of the CCP under the relevant insolvency regime were such tools to be insufficient.

Q16: What is the appropriate NCWO counterfactual for a resolution scenario involving non- default losses? Is it the liquidation of the CCP under the applicable insolvency regime, assuming the prior application of any relevant loss allocation arrangements for non-default losses that exist under the CCP's rules or another counterfactual?

The appropriate counterfactual is likely to be, as a matter of law, the application by the CCP of all of the loss allocation tools available under its rules followed by the liquidation of the CCP under the relevant insolvency regime were such tools to be insufficient.

Q17: How should the counterfactual be determined in cases that involve both default losses and non-default losses?

The approaches set out in our response to both Q15 and Q16 would have to be applied to the relevant loss.



Q18: Should CCP owners' equity be written down fully beyond the committed layer of capital irrespective of whether caused by default or non-default events?

We refer to the EACH response.

Q19: Should new equity or other instruments of ownership be awarded to those clearing participants and other creditors who absorb losses in resolution?

We refer to the EACH response. We also stress the effect which changing the incentive structure for clearing members may have – this may be prejudicial to the successful recovery of the CCP.

Q20: What are your views on the suggested standing composition of CMGs? Should resolution authorities consider inviting additional authorities to the CMG on an ad-hoc basis where this may be appropriate?

We refer to the EACH response.

Q21: What should be the nature of engagement with authorities in jurisdictions where the CCP is considered systemically important, for the purpose of resolution planning and during resolution implementation?

We refer to the EACH response.

Q22: Should CCP resolution authorities be required to disclose basic information about their resolution strategies to enhance transparency and cross-border enforceability? If so, what types of information could be meaningfully disclosed without restricting the resolution authority's room for manoeuvre?

We agree with EACH that the full suite of powers available to the resolution authorities should be agreed ex-ante, disclosed publicly and to the extent possible



included in the CCPs' rules. Further, as much information as possible should be shared by the resolution authority with the CCP as part of any *ex ante* resolution planning. Joint planning between the CCP and the resolution authority should be undertaken on a periodic basis and the resolution authority should indicate to the CCP which resolution tools it is likely to favour and in what order it would be likely to implement them. Such an approach will maximize the likelihood that a CCP's rules will support any action undertaken by a resolution authority. However, as noted above, we accept that the resolution authority should retain a certain measure of flexibility in its application of resolution tools. Please also refer to the comments in Q1 above relating to co-operation between resolution authorities and CCPs on resolution plans.

Q23: Does this section of the note identify the relevant CCP-specific aspects of cross border effectiveness of resolution actions? Which other aspects, if any, should also be considered?

We refer to the EACH response.

Q24: What should be the role, if any, of the suspension of clearing mandates in a CCP resolution and how should this be executed in a cross-border context?

We refer to the EACH response.

Yours sincerely,

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