

Monday 17<sup>th</sup> October 2016

**FINANCIAL STABILITY BOARD (FSB) DISCUSSION NOTE:  
ESSENTIAL ASPECTS OF CCP RESOLUTION PLANNING**

<b>INTRODUCTION</b>
---------------------

The World Federation of Exchanges (WFE) is the global trade association which represents more than 200 Financial Market Infrastructures (FMIs), of which more than 100 are Central Counterparties (CCPs) and Central Securities Depositories (CSDs). Our members include exchange groups as well as standalone CCPs<sup>1</sup>.

Our members are both local and global, operating the full continuum of Financial Market Infrastructure in both developed and emerging markets. Of our members, 36 percent are in the Asia-Pacific region, 42 percent in EMEA and 22 percent in the Americas. The market capitalisation of entities listed on our member exchanges is \$68.5 trillion, and around \$26 trillion in trading annually passes through the infrastructures our members safeguard<sup>2</sup>.

The WFE works with standard setters, policy makers, regulators and government organizations to support and promote the development of fair, transparent, stable and efficient markets around the world.

The WFE has previously publicly expressed support for initiatives such as the CPMI-IOSCO Principles for Financial Market Infrastructure (PFMI) and the FSB Key Attributes, and has sought to proactively contribute to the international debate on these issues and others – including CCP risk management, recovery and resolution<sup>3</sup>. In doing so, its members have contributed significantly to the strengthening of the system via the implementation of many post-crisis initiatives, including efforts to encourage central clearing of derivatives as per the G-20 direction.

The WFE and its members share the FSB's goals of ensuring the safety and soundness of the global financial system, which is critical to enhancing investor and consumer confidence, and promoting economic growth. In that context, WFE appreciates the opportunity to respond to this Discussion Note<sup>4</sup> relating to CCP Resolution Planning.

---

<sup>1</sup> The WFE membership list [can be found here](#)

<sup>2</sup> As at end 2015

<sup>3</sup> [WFE: CCP Risk Management, Recovery and Resolution – Aligning CCP & Member Incentives](#)

<sup>4</sup> FSB Discussion Note: [Essential Aspects of CCP Resolution Planning](#)

## EXECUTIVE SUMMARY

As the FSB is aware, FMIs performed well through a range of significant market stress events including the 2008 global financial crisis and - more recently - in the global market volatility seen in August 2015 and at the beginning of 2016. Despite their impressive track record through stressed market conditions, FMIs continue to refine and improve their resilience and ability to manage future market crises as the core function of their offering.

Whilst we consider recovery is almost always preferable to resolution, the WFE nevertheless welcomes well-designed international efforts to enhance and strengthen how CCPs will be resolved if the worst was to occur – such as a simultaneous default of several of the largest globally systemic banks. We therefore generally support further initiatives which encourage better planning by resolution authorities, in particular where such initiatives encourage the necessary international cooperation between regulatory bodies. This is an area in which international standard setters such as the FSB should - and do - play a leading role, and where trade associations with an international constituency – such as WFE - can support its delivery.

However, within that context, we respectfully note:

- **It is not likely that one single resolution strategy will be effective for all potential scenarios**, and which allows for the nuances and specificities of each event to be considered. Markets - and the firms operating within them - vary, as do national and regional laws and regulations. We appreciate the acknowledgement in the FSB consultation that arrangements need to reflect and accommodate these idiosyncrasies in the market.
- **Recovery must be given every opportunity to be successful.** A CCP's recovery plans will include robust and appropriate tools that have been developed using industry guidance<sup>5</sup> and reviewed by the relevant authorities. A CCP recovery will almost always be preferable to its resolution because of the latter's implications on the wider economy. Resolution should only be triggered if it is necessary to provide for continuity of clearing services and market stability once all recovery measures have been exhausted.
- **There is no benefit to limiting the tools available to a CCP in managing its own recovery.** The extreme yet highly specific nature of each scenario that could put a CCP into recovery will require an ability for it to take decisions based on expert judgement and use all relevant tools available to enable it to take into account – and address and mitigate – the risks arising from that specific set of circumstances.
- **Existing obligations and incentive structures need to remain appropriately balanced** in order to support the CCP function in either recovery or resolution situations. Certainty, reliability and fairness – including retaining incentives to ensure all stakeholders behave appropriately and in the interests of the wider market - will be necessary to facilitate a return to normal market functioning.

---

<sup>5</sup> For example, the guidance provided by CPMI-IOSCO's Recovery of Financial Markets Infrastructure report

- **The ultimate “cost” to end-users needs to be considered** – including relating to access to clearing. WFE has previously publicly noted its concerns around the effects on the wider cleared markets of unduly increasing capital requirements<sup>6</sup>. Increasing requirements relating to pre-funding to support a recovery or resolution would likely have similar effect, be generally at odds to the wider G-20 push post-crisis, and furthermore could have negative impacts on financial stability.

In summary, whilst advocating that recovery should be given every opportunity to succeed, any resolution framework or guidelines need to retain sufficient flexibility to ensure the continued smooth operation of the wider market in the event of a resolution situation. Further, they should not conflict with existing rules or expectations, nor create unintended consequences for the orderly and safe operation of the market. Markets are increasingly international, although continue to operate within regional or local market structures, laws and regulations. As such we would support here, as on other topics, a set of globally applicable principles (rather than prescriptions), which would facilitate a more integrated financial system while enabling regulators and FMIs to consider and respond appropriately to the unique nature of local markets.

Our comments below seek to further elaborate on these issues, setting out our analysis and likely consequences that might arise as a result of some of the matters raised within the Discussion Note.

#### GENERAL REMARKS

FMIs are a critical part of the global financial markets and play a key role in mitigating risks for all participants in the markets they serve. FMIs have proven to be part of the post-crisis solution, enabling companies to raise capital and manage risk, helping economies recover and grow following the largest global recession of modern times in addition to offering a bedrock of systemic stability.

The WFE welcomes international efforts to enhance and strengthen the financial system through regulatory reforms that will – amongst other things - increase market confidence whilst reducing systemic risk.

FMIs have responsibilities to achieve public policy objectives of safety, efficiency and reducing systemic risk. To effectuate this, they themselves have detailed rules and standards which users of the FMI must meet. This would include - but not be restricted to – systems and controls and trading conduct. It is therefore important generally applicable rules or principles do not conflict with FMI specific rules which were designed in the interests of fair and orderly (and resilient) markets.

CCPs may operate in many jurisdictions and clear products which are globally traded and so it is important this international framework is consistently applied across jurisdictions. WFE has previously expressed support for the principles-based approach through which existing global CCP standards have been developed. This has enabled CCPs to employ prudent risk management practices which are able to sufficiently flex to fit the national/regional legal and regulatory requirements in which they operate, alongside suiting the nuances of the products and markets that they clear for.

With regard to the specific questions within the Discussion Note, we respond as follows:

---

<sup>6</sup> C.f. [WFE letter to the BCBS](#) relating to the Leverage Ratio

<b>SPECIFIC COMMENTS</b>
--------------------------

## **1. SCOPE**

***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?***

The WFE considers the Discussion Note covers the relevant areas. However, we reiterate the unique position the resolution authority has in the market, particularly for the purposes of defining what type of actions could have a negative impact upon financial stability. Similarly, we advocate the resolution authority should largely play a monitoring role during a CCP recovery (particularly regarding participant behaviour - which it should take into account when deciding the point in time in which to invoke its resolution powers - and which of the specific tools it will apply to appropriately address the situation).

## **2. INCENTIVE EFFECTS OF RESOLUTION STRATEGIES**

***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?***

In general, the WFE considers a CCP-led recovery is preferable for the broader market than a resolution situation, and should therefore always in the first instance be given an opportunity to be successful. Within this, there should be clear incentives to encourage clearing participants' behaviour towards making successful such a recovery.

Of the aspects described, one of the main impacts on incentives would be the overt publicising of all presumptive steps and timing of entry into resolution. This is because such information may provide adverse incentives for participants to precipitate resolution, or to not fully participate in recovery, if they are aware of the next steps which they perceive to be more commercially beneficial. Given this, we therefore consider this answer also partly relates to Q3.

Whilst we consider a full publication of presumptive steps and entry points would likely create unintended consequences (as described above), it may be useful to publicise some discrete aspects of the tools available, and the potential losses they may cause, in order to engender positive incentives for participants. For example, regarding the timing of entry for resolution, it would be prudent for the resolution authority itself to explain – in the recovery period - it is explicitly monitoring the behaviour of CCP participants which may be a relevant factor it takes into account regarding when to invoke the resolution plan, or which tools to apply to participants. Particularly those who may stand to benefit more if the CCP's resolution was expedited. Such a statement should also note any such disingenuous behaviour is strongly discouraged.

Further, we suggest resolution authorities should also be extremely careful when choosing to suspend mandatory clearing. Such a suspension would create incentives for participants not to clear and be involved as fully in recovery or resolution. It may also precipitate a CCP resolution as its margin and default fund would be further depleted precisely at a time when such financial resources are under stress. Ideally, therefore, this step should be taken only in the most extreme cases of financial instability.

### **3. TIMING OF ENTRY INTO RESOLUTION**

***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?***

The decision regarding when to invoke resolution should only be taken after a CCP's recovery plan - as defined in its rulebook - has been exhausted or if the continuation of the recovery plan is clearly going to exacerbate the stress on the financial markets. Recovery must be given every opportunity to be successful, particularly as resolution would inevitably have more of a negative market impact. As such, the factors for determining timing of entry into resolution will be dependent on the particular stress scenario threatening the CCP.

In order to ensure CCP participants do not precipitate the triggering of resolution, it would be useful for the resolution authority to explain it will closely monitor the behaviour of clearing participants in a CCP's recovery plan and loss allocation mechanism - which will be explicitly taken into consideration when deciding the point in time to invoke resolution and the specific tools it will apply to appropriately address the situation. This would serve as a deterrent for participants to engage in behaviour purely designed to precipitate a CCP resolution as an authority may decide that, because of such behaviour, all recovery avenues have not yet been explored and so prolong a resolution decision.

WFE does not however believe it appropriate for a resolution authority to publicise any other timing of entries. This is because it is almost impossible to predict the order in which certain situations will occur, and may provide perverse incentives for participants to change behaviour to ensure presumptive steps are reached. Furthermore, if a resolution authority's complete strategy and timings of entries is public, it risks being hamstrung and not able to take into account the specificities of the situation or unforeseen circumstances.

We therefore consider there a need to strike the right balance between providing sufficient certainty to participants (including the CCP) and leaving the authorities with enough flexibility – bearing in mind the significant risks which would be created by early entry - to make the correct decision to preserve and protect market stability.

### **4. ADEQUACY OF FINANCIAL RESOURCES IN RESOLUTION**

***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?***

When working to define the appropriate amount of pre-funded resources contributed by the CCP, it is crucial to balance the potential for increased security with the need to ensure appropriate incentives for clearing members. Unduly large CCP contributions can act to subsidise the risk of, and create the wrong incentives for, market participants both on an ongoing basis and during a default event as they are less likely to be subject to loss. CCP contributions, as with other contributions, should therefore be balanced and commensurate with the risk bought to the clearing system.

We also note the risk that the imposition of additional CCP pre-funded resources may reduce the focus on the default management process - which is at the core of the CCP's role in the financial system - as well as distort incentives for participants vis-à-vis risk management.

Additionally, we provide general caution to further increasing financial resource allocation to the clearing ecosystem. The recent ESMA proposal<sup>7</sup> to delay implementation of the clearing mandate for Category 3 financial counterparties was in part due to the acknowledgement end-users are finding it increasingly difficult to locate clearing members willing to support their clearing activity due to general increases in capital costs.

***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?***

As in our answer to Q4 above, we do not believe that CCPs should be required to hold additional pre-funded resources specifically for resolution. Ultimately, we believe that the risk of loss must lay with the defaulting entity. In a default event, CCPs contribute a defined amount to the waterfall to ensure (and demonstrate) their alignment with the interests of their clearing members. However, the final risk of loss must remain with the clearing members to both encourage them to avoid default to the clearing house, and to participate actively in the default management process to avoid losses affecting their mutualised contributions. In this case, the CCP does not contribute to market risk which could lead to a default, nor do CCPs have the ability to participate in the default management process, which relies on active bidding on the defaulter's portfolio. Determining the quantum for these losses at the CCP must consider these factors.

For non-default losses, CCPs may be more or less responsible for the losses depending on the type of loss. Where the CCP is responsible for the decisions which could theoretically make losses more or less likely (i.e. employee fraud or systems failure, or investment losses), the CCP should be responsible for the losses. Most jurisdictions require CCPs to hold significant capital to support the losses which may be caused by a non-default event, requiring it to be appropriately sized based on the amount needed to continue operating the CCP and providing its services to the market.

***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?***

Again, in defining funding requirements, the ultimate cost to end-users must be considered. If additional funding is required of clearing members, it will increase the cost of clearing and could result in fewer firms willing to provide client clearing services (as described in the response to Q2 and Q4).

In addition, if clearing members are asked to contribute into a specific fund beyond the waterfall, it is unlikely that clearing members of all sizes would be able to participate. Relying on such funding will result in concentration of clearing member risk as smaller clearing members are unable to participate in a default situation; having a concentrated or limited clearing member pool will, for example, make it more difficult to auction the portfolio and port clients.

---

<sup>7</sup> [ESMA Consultation Paper](#) on the Clearing Obligation for Financial Counterparties with a Limited Volume of Activity

Further, in developing markets, it may be there are no clearing members are able to continue client clearing operations.

Markets should not sacrifice access to clearing and the benefits of diverse participation in order to prepare for a scenario which regulators have defined as extreme and implausible. We suggest a more pragmatic approach would be for CCPs to use cash calls, which would be relatively small compared to variation margin call sizes and the liquidity resources of globally systemically important banks.

## **5. TOOLS TO RETURN TO A MATCHED BOOK**

***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 WFE believes all decisions undertaken by the resolution authority, including type and order of tool applied, should be taken with the success of the recovery as the primary focus. The tools defined in the CCP's recovery plan will normally result in a return to a matched book. The determination of which tools are preferable will only be possible during the execution of the recovery process, in light of the particular facts and circumstances of the event in question. The CCP will define the tools available to them in its recovery plans and rulebook.

In particular, strategic partial tear-ups – after multiple auction rounds where the CCP and participants can identify the markets which may no longer be necessary – is a crucial tool to ensure that CCPs can restore a matched book. Where a small subset of toxic or obsolete products have proven to be unnecessary to the market through multiple failed auctions, CCPs should be able to tear up these contracts to avoid more significant losses to the broader market.

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

The market will not benefit from limiting the tools available to a CCP to effect its own recovery. CCPs are the foremost experts on the markets which they clear and will be the most capable to efficiently use the tools designed to return to a matched book. Failing to recognize this point - and limiting the tools available to a CCP during recovery - will undermine market stability and prevent CCPs from using the flexible, fact specific decision making that allowed CCPs to successfully navigate numerous stress events, including the 2008 financial crisis. This would be particularly perverse considering – given its success during the crisis - the central clearing model has subsequently been used as a model for other parts of the financial industry.

## **6. ALLOCATION OF LOSSES IN RESOLUTION**

***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?***

Initial margin haircutting should not generally be considered as a loss allocation technique in resolution, unless permitted as a recovery tool under the regulatory regime applicable to a particular CCP and provided for under the CCP's rules. We believe that other tools are more appropriate and

more effectively allocate losses to those who bring the most risk and are in the best position to absorb the losses.

Partial tear-ups, as described in Q7, are an appropriate tool to manage extreme scenarios and target losses to the markets/products which have demonstrated a lack of viability.

Variation gains haircutting, as an extreme loss allocation tool, effectively focuses losses on those market participants who are in a position to absorb losses in an unprecedented market event and so can be useful.

***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)?***

Resolution authorities should be responsible for assessing the negative impact on financial stability from an action performed by the CCP during recovery.

Again, we believe that there is no benefit to limiting the tools available to the CCP in managing its own recovery. Generally, loss allocation tools should only be used by CCPs as they are best placed to manage an orderly recovery process. However, resolution authorities should - throughout the recovery process - have sight of the process to ensure there are no measures undertaken by the CCP which have a negative impact upon financial stability.

There may be instances where a CCP's measures to manage credit, liquidity or business risk unduly impacts upon the going concern of a clearing participant which may have wider financial stability implications. A CCP, in the throes of implementing a recovery plan, should not be expected to ascertain the macro-economic impact of its policies and procedures as it may be that, in that situation, they do not reconcile with a CCP's responsibility to ensure the safety and efficiency of its market. Resolution authorities should therefore share as much information with the CCP relating to the wider market to ensure prudent decisions can be taken.

In the event a resolution authority does intervene and decide to manage the CCP's loss-allocation due to financial stability concerns, it should be transparent to the market the precise reasons for deviating from the CCP's plan.

We note in sections in 6.5 and 6.6 of the Discussion Note the statement that it is the resolution authorities' responsibility to *'help reinforce incentives for members to participate in the CCP's default management and recovery processes prior to entry into resolution. (Any strategies should avoid creating incentives for participants to avoid supporting recovery in favour of resolution because they think they will be better off.)'*

We suggest this be strengthened to include that the resolution authority should strongly encourage participants to participate in a CCP's recovery process (where appropriate), having already assessed the viability of the recovery plan, in particular its effects on financial stability and pro-cyclicality. For example, temporary capital relief for "winners" of portfolios during an auction is one incentive that regulators might consider to encourage such participation.

**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?**

The WFE generally supports a flexible and discretionary approach rather than fixed as set out in a CCP's rules. This further reinforces our view that all possible presumptive steps and entry into resolution should not be made public. The resolution authority should be able to deviate from a CCP's rules in terms of *pari passu* in certain instances - depending on the situation. Such an ex-ante policy (i.e. that a deviation is possible) should be made public, as should the specific instances of why this specific deviation was made (unless such transparency regarding *pari passu* is considered by the resolution authority to create perverse incentives for market participants).

Relating to the implications of a resolution strategy based on fixed order of loss allocation, we consider that a fixed order of loss allocation in a CCP's rules - whilst clear for market participants - may not be able to contain sufficient flexibility in order to explain where loss allocation needs to be revised due to financial stability considerations, or other (such as through variation margin gains haircutting and partial tear-ups). Additionally, excessive transparency may result in participants behaving in a manner that serves their best interest rather than the interests of the broader market, if they believe that the potential benefit of reaching the end of the plan (i.e. compensation) are worth the losses of the defined steps. In this case, we believe that constructive ambiguity, where the next steps are not fully known to the market, will encourage better behaviour by market participants. The WFE believes resolution authorities - despite some discrete flexibility written into a CCP's rules - should not be dictated by them in order to ensure positive behaviour from market participants.

Conversely, a loss allocation strategy which is exclusively executed by the resolution authority fails to fully appreciate the knowledge and expertise of the CCP in managing its own market and also creates uncertainty for participants which would impact upon its credit and liquidity management. In the event a resolution authority does intervene and decide to manage the CCP's loss-allocation (due to financial stability/pro-cyclicality concerns), it should be transparent to the market its precise reasons for doing so ex-post, where appropriate.

**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?**

(i) *The preferred approach of the resolution authority to allocating losses:*

- a. Rules can only define the approach for managing default and non-default losses to a certain point, and this should be codified in the CCP's rulebook. After all, upon resolution, the CCP is no longer in the lead and the resolution authority needs to have as much flexibility as possible so as to ensure an orderly wind-down. A CCP's rules are reviewed by regulators and must be deemed appropriate given the regulatory requirements of the given jurisdiction, although they should really only address recovery.

- b. It is expected that the regulatory requirements defined and reviewed by the CCP's supervisory authority will align with the preferred approach of the resolution authorities.
  - c. If losses reach a level beyond extreme but plausible, as defined and reviewed by regulators<sup>8</sup>, the CCP and participants will be, by definition, in a scenario that is unprecedented and it would be premature to define a preferred approach in advance of these circumstances, without any knowledge of the unique characteristics of the market situation that led to the scenario.
  - d. CCPs should have the available tools to manage extreme but plausible scenarios during recovery defined in their rulebook, but the resolution authority should have flexibility and not be bound by CCPs' rules, once resolution has been invoked.
- (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:*
- a. Again, the loss allocation tools defined in the recovery plan and rulebook must be reserved for the CCP to use during the recovery process. Limiting the permitted tools available to the CCP will only serve to reduce the likelihood of the CCP's recovery.

## **7. NON-DEFAULT LOSSES**

### ***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?***

See combined response to Q13 and Q14 below.

### ***Q14. Aside from loss allocation, are there other aspects in which resolution in non-default scenarios should differ from member default scenarios?***

Q13-14 combined.

The allocation of losses during a non-default event must be based on the source of the losses, the profile of the CCP in taking the risk and the CCP's policies in managing these risks. For example, some CCPs allow clearing members to dictate where their money is invested after deposit at the CCP. In these circumstances, we would expect that clearing members are responsible for the losses, as they managed the decision as to where their money was held. In other circumstances, such as a severe operational failure on behalf of the CCP or where the CCP independently invests financial resources, we would not expect losses to be allocated to clearing members, as the management of those risks was solely the responsibility of the CCP. That said, in the case of idiosyncratic losses (e.g. a cyber-attack), or delay of access due to custodian or a settlement bank failure, it would not be appropriate for losses to be wholly borne by the CCP as it is in conflict with the CCP's role in the financial ecosystem and inconsistent with protections offered by custodian/settlement banks.

---

<sup>8</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-results-eu-central-counterparties-stress-test>

Specifically regarding Q14, since clearing members are not in as much control about whether the CCP will reach resolution in a non-default situation, the concerns about perverse incentives of compensation will be somewhat dampened.

## **8. APPLICATION OF THE “NO CREDITOR WORSE OFF” (NCWO) SAFEGUARD**

***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?***

See combined response to Q15-Q17 below.

***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?***

See combined response to Q15-Q17 below.

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

Q15-17 combined.

We believe the NCWO principle is important to market participants but it is possible to be structured so as to give resolution authorities the necessary flexibility to operate appropriately. However, it is also important to note that any loss allocation by a resolution authority that differs from the CCP rulebook allocation could create a class of creditors for which NCWO fails.

In answer to the second part of Q16, the simple answer is yes; however, resolution authorities should consider - in a particular event - what the costs of the counterfactual are (e.g. increased exposure from re-bilateralisation) if the CCP’s markets are used for cash bond or real loan hedging.

There are also nuanced counterfactuals based on the type of loss e.g. default or non-default. In the case of a default loss, there should be a comparison between the potential actions of the resolution authority and the scenario where the CCP would continue to allocate losses and execute its powers according to the rulebook (assuming members were to fully comply with the tools, and the subsequent effect of insolvency). For non-default losses, there would need to be a comparison between the potential actions of the resolution authority with the scenario of a CCP liquidation under the applicable insolvency regime assuming the prior application of any relevant loss allocation arrangements for non-default losses which exist under the CCP’s rulebook

Nevertheless, as noted above we believe NCWO can be structured in a way which gives resolution authorities the necessary flexibility to operate appropriately.

Specifically related to Q17, the only difference is that the waterfall would not be used to address non-default losses so any costs associated with the waterfall would not be considered.

## **9. EQUITY EXCHANGE IN RESOLUTION**

***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?***

Whilst it is appropriate for a CCP to have 'skin-in-the-game' for both instances, it is not appropriate for a CCP owners' equity to be fully drawn down when the issue was caused by a clearing member default.

Conversely, in a non-default scenario which was wholly the fault of the CCP i.e. not a custodian/settlement bank failure, such an equity write down could be appropriate. However, in both cases, the specific facts of each case will need to be assessed by the authority. It is very difficult - and often counter-productive - to prescribe a defined approach ex ante.

Whilst the rule should state a CCP's own funds should not be depleted in a default scenario, there may be exceptions where the resolution authority considers the CCP (i.e. due to mismanagement of its recovery plan, or financial resources) should be part of loss allocation; however, it is of vital importance such a presumptive condition is not made public so as not to create moral hazard amongst participants.

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

Equity can be a highly inappropriate tool to compensate clearing members in the event of CCP resolution, especially if it results in a clearing member having overall control of a CCP, which can distort the dynamics of the CCP's functioning to the detriment of other participants. Such a clearing member hegemony was specifically removed in recent legislation, such as EMIR.

We consider this could also skew incentives during recovery, giving members motivation to allow recovery to fail if they are able to benefit from equity upon resolution. This is a particular risk if the member has already suffered significant losses during recovery, as is likely to be the case under these unprecedented circumstances. In this situation, it is possible they view the losses as a 'sunk cost' and decide to accept the (relatively little) additional costs to secure an equity stake.

Additionally, with CCPs offering clearing in multiple asset classes, there may be a scenario where, if a single asset class fails, an equity stake for members of that asset could end up also with ownership of the other asset classes, creating an inappropriate relationship for members of those asset classes.

However, if an equity transfer was guaranteed not to create such any self-interested behaviour (as described above), some form of compensation may be appropriate.

Overall, other methods of compensation beyond transfer of equity may be appropriate and should also be considered.

## **10. CROSS BORDER RESOLUTION**

***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?***

See combined response to Q20-Q22 below.

***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?***

See combined response to Q20-Q22 below.

***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?***

Q20-22 combined.

The WFE is a strong proponent for, and advocates the importance of, cross-border cooperation in order to ensure sound, smooth and orderly markets. However, we also caution that the CMG should not become too unwieldy, incorporating too many authorities, which would delay decision-making. In these circumstances, the home authority must play a leading role in the CMG, due to their in-depth understanding of the CCP, expertise in the markets which the CCP clears, and their legitimate interests/rights based on the local legal/regulatory framework.

Similarly, we urge that members of the CMG should be technicians and that political discussions should be avoided.

Specifically relating to Q22, the answer could be yes, but only in discrete instances e.g. to specify instances which would constitute financial instability for the purposes of non-loss allocation.

## **11. CROSS-BORDER EFFECTIVENESS OF RESOLUTION ACTIONS**

***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 consider the majority of relevant CCP-specific aspects are mentioned. However, cross-border issues and cooperation should be examined in more detail to prevent international financial instability due to resolution measures applied.

***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 caution that a suspension would likely add further systemic risk to an already highly stressed environment. Any clearing continuum would help the CCP to recover and a forced reduction in central clearing would simply exacerbate the CCP's resolution which runs counter to the incentives and goals

of the G-20. Additionally, the promise of a suspension of the clearing mandate may encourage members to allow a CCP to reach an otherwise avoidable resolution.

Ultimately, it is our view that nothing the resolution authority does should undermine recovery; further, we caution that dis-applying a mandatory clearing structure which has proven its robustness during times of stress does not necessarily reduce systemic risk (which should be the authority's ultimate intention).

<b>CONCLUSION</b>
-------------------

The WFE and its members are committed to ensuring the trading and clearing environments they operate are secure, stable and resilient.

The WFE welcomes international efforts to enhance and strengthen the financial system through regulatory reforms that will – amongst other things - increase market confidence whilst reducing systemic risk. Investor confidence in public markets is crucial for the industry and, as markets evolve – and as G-20 mandates continue to be implemented encouraging greater central clearing of financial markets – legislators and FMIs should work together to ensure that risks are appropriately mitigated without undue or unintended consequences.

Whilst we consider that recovery must be given every opportunity to be successful – given a CCP recovery will almost always be preferable to its resolution because of the latter's implications on the wider economy – it is important nonetheless to have clear resolution expectations in the event the recovery plan has been exhausted. In particular we note:

- It is not likely that a single resolution strategy will be effective for all potential scenarios. Markets – and firms operating within them – vary, as do national / regional laws and regulations. As such we appreciate the FSB's acknowledgement that arrangements need to flex sufficiently and reflect that.
- There is no benefit to limiting the tools available to a CCP in managing its own recovery.
- Early intervention by the resolution authority is a signalling event that will undermine any chances of recovery by the CCP outside of resolution.
- The ultimate cost to, and effect on, end-users needs to be considered. We therefore caution the extent to which proposals affect access to clearing through, for example, increased capital expectations and/or requirements relating to pre-funding to support a recovery or resolution.

- Resolution authorities are best placed to ascertain whether certain CCP-policies or procedures impact upon financial stability but they should share information with the CCP to promote a positive recovery outcome and they should also provide guidance to market participants, where possible, in order to provide appropriate incentives for participation in a CCP's resolution.
- Transparency obligations need to be balanced to ensure they do not create incentives for market participants to behave in a manner which is purely self-serving and not for the benefit of the broader market.
- Equity is an inappropriate tool to compensate members in the event of CCP resolution, because it may inappropriately skew incentives for market participants.

Ultimately, we are working towards the shared objectives of achieving fair, robust and resilient markets in which investors can have confidence. In that regard, the WFE and its members stand ready to work with national and international agencies to ensure this.