1 February 2017

Essential Aspects of CCP Resolution Planning

Overview of Responses to the Discussion Note

On 16 August 2016, the FSB published a discussion note on *Essential Aspects of CCP Resolution Planning*[1] that sought comments on aspects of central counterparty (CCP) resolution that are considered core to the design of effective resolution strategies.

The FSB received 38 responses including from CCPs, participants, industry associations and other infrastructure providers.[2] Most respondents expressed overall support for the objectives of resilience, recovery and resolvability of CCPs and welcomed the FSB's engagement on the topic.

This note summarises the main themes emerging from the responses to the discussion note, and identifies where these themes are considered in the consultative document *Guidance on Central Counterparty Resolution and Resolution Planning* ('The Guidance').[3]

1. Objectives of CCP resolution and resolution powers

Most respondents agreed that the key objective of CCP resolution must be the continuity of essential CCP functions for the participants and markets served by the CCP, stressing the overarching objective of maintaining financial stability and minimising systemic risk. A small number of respondents said the objective should be a rapid closeout and the return of capital once the CCP's recovery plan had failed.

Respondents overall supported broad powers for the resolution authority.

The Guidance on objectives of CCP resolution focuses on continuity of critical functions, alongside maintaining financial stability.

The Guidance on resolution authority and powers in Section 2 supports that the resolution authority should have all the powers that are necessary to support an orderly resolution, and that it should be able to wind down operations not judged to be critical functions.

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[1] Financial Stability Board, *Essential Aspects of CCP Resolution Planning,* August 2016 (www.fsb.org/2016/08/essential-aspects-of-ccp-resolution-planning/)

[2] Responses are published on the FSB's website (with the exception of those that requested otherwise): www.fsb.org/2016/11/public-responses-to-the-august-2016-discussion-note-on-essential-aspects-of-ccp-resolution-planning/

[3] Financial Stability Board, *Consultative document on Guidance on Central Counterparty Resolution and Resolution Planning*, January 2017 (www.fsb.org/2017/02/guidance-on-central-counterparty-resolution-and-resolution-planning/)

2. Timing of entry into resolution

The majority of respondents stated that there should not be an automatic or presumed point of entry into resolution, allowing the possibility for a CCP-led recovery to continue and provided that implementation of recovery measures is subject to regulatory supervision and oversight. Most asserted that recovery is preferable to resolution and that the CCP should be permitted to apply its recovery plan before authorities step in.

Most respondents preferred 'constrained flexibility' with qualitative guidance or indicators from authorities, broadly in line with the criteria set out in the FMI Annex to the *Key Attributes*[4] and the discussion note. Respondents asserted that entry into resolution should occur only when the recovery plan 'fails' including failing to return to a matched book.

Some respondents supported the early involvement and engagement (as opposed to the intervention) of the resolution authority during the CCP's recovery actions, to keep up to speed with developments and offer systemic oversight. Some respondents asserted the need for 'extraordinary tools' to be under the control of the authorities.

Respondents generally welcomed disclosure by resolution authorities of aspects of resolution tools and planning.

Section 3 of the Guidance discusses potential indicators of circumstances that could lead to a determination to trigger resolution for both default losses and non-default losses, but does not propose automatic trigger points. It notes that resolution authorities should consider communicating publicly some of the indicators that would inform their decision to trigger resolution.

3. Tools to return to a matched book

It was noted that the choice of tools for forcing a matched book is highly dependent on the asset class or market segment in question.

Respondents expressed a range of views on **partial tear up** (PTU), though most viewed it as a 'least bad option' for returning to a matched book if other actions fail. For some, PTU is an 'extraordinary' tool which should only be used in resolution. Some asserted that even in resolution, a PTU should only be carried out in consultation with, or with the consent of, affected parties.

Many respondents wanted compensation such as in the form of senior debt claims for use of PTU though some acknowledged this will be difficult to value.

Many comments did not support **forced allocation** as an appropriate tool. **Full tear up** is seen as an undesirable last resort measure to be avoided if at all possible, but some thought it should still be part of the CCP rules for completeness (including where it is decided to close a service).

CCPs did not support the reservation of any tools (including loss allocation tools) to resolution.

The Guidance addresses tools to return to a matched book in Section 2 and addresses these three tools. It notes that these tools should only be used where market based actions to return to a

[4] Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October 2014 (www.fsb.org/2014/10/r_141015/)

matched book have failed or are expected to fail; and that forced allocation and full tear up should only be used as last resort tools.

4. Allocation of losses in resolution

Most responses discussed the tools they considered appropriate for loss allocation in general, not necessarily just for resolution. **Cash calls** seem widely accepted as the first tool after prefunded resources have been exhausted. Some responses mentioned and supported a specific resolution authority cash call either at the point of entry into resolution or ahead of haircutting tools.

The responses covered the full range of views on **variation margin gains haircutting** (VMGH) and similar tools. Some believe VMGH is an effective and efficient loss allocation tool, as it distributes losses, and therefore risk, widely and creates the right incentives. Others believe that the use of VMGH could have knock-on effects in an already distressed market and should, if at all, only be used after exhaustion of funded and unfunded mutualised resources, provided that it is administered by a resolution authority in resolution.

The large majority of respondents strongly opposed **initial margin haircutting** (IMH) and observed that if IMH is permitted in some jurisdictions but not others it could drive clearing members to clear only through CCPs in jurisdictions that prohibit IMH. A small number suggested it could be used as a last resort tool where it is not bankruptcy remote or to wind up the CCP.

Several respondents suggested that clearing participants suffering losses from the use of loss allocation tools utilised after exhaustion of funded (i.e. default fund) and unfunded (i.e. capped assessments) mutualised resources, and position allocation tools utilised upon the failure of the CCP's auction (or similar mechanism to rebalance its book), should obtain **senior debt claims in return** so as to become 'creditors' in order to benefit from creditor protections in resolution such as "no creditor worse off" (NCWO). Other respondents stated that this would distort incentives to support actions earlier in the default management process and may lead to participants preferring resolution.

Loss allocation tools for both default and non-default losses including cash calls, VMGH and write-down of unsecured liabilities are addressed in Section 2 of the Guidance. Section 2 also notes that the resolution authority should have the power to award appropriate amounts of equity or other instruments of ownership (or debt instruments convertible into equity) to clearing members that contributed financial resources to a resolution in excess of their obligations under the CCP's rules and arrangements.

5. Flexibility vs. predictability

Regarding **flexibility**, a number of respondents expressed the desire for resolution authorities to follow the rulebook of the CCP to provide as much certainty as possible in resolution, but accepted that resolution authorities may need to have some flexibility only after CCP arrangements have been exhausted. A number of responses also suggested that resolution authorities should carefully consider any disparate treatment of creditors, exercise relevant powers judiciously and should disclose publicly whether resolution strategies contemplate any potential deviation from the *pari passu* treatment of creditors.

Most respondents sought clarity and transparency on which tools will be available to the resolution authority.

Some responses asserted that loss allocation should always be in line with the CCP's rulebook with one requesting an express prohibition on emergency powers in CCP rulebooks.

The Guidance notes in Section 2 that, upon entry into resolution, there should be a presumption that the resolution authority continues to follow the steps and processes under the CCP's rules and arrangements where it intervenes before these have been exhausted, as these will be known to the CCP, its participants and the markets served by the CCP. But if necessary to achieve the resolution objectives and avoid significant adverse effects on the financial system, the resolution authority should be able to refrain from enforcing certain contractual obligations under the CCP's rules and arrangements or otherwise depart from the CCP's rules and arrangements subject to explicit limits and safeguards.

The Guidance does not stipulate a particular order of use of tools as this will be dependent on a number of factors such as those identified in Section 7. It notes that resolution authorities should consider the merits of publicly disclosing some elements of the resolution plan.

6. Non-default losses

Some respondents strongly felt that participants should not have to bear non-default losses given that only the CCP's management is able to control and mitigate the CCP's exposure to non-default losses. Many felt they did not have enough transparency from CCPs regarding non-default risks and how they would be managed/allocated and that these should be written into CCP rulebooks.

Respondents also felt that in the event that regulatory capital does not cover non-default losses, additional losses should be covered exclusively by any additional CCP equity and/or a parent company of the CCP. Any intercompany debt owing to a CCP's parent should be junior to claims for non-default losses. It was also suggested that to create the right incentives for the CCP and its management, CCP rulebooks should unambiguously indicate that default "waterfalls" do not apply to non-default losses. Some acknowledged that in extremis, after CCP capital has been written down and no other solutions are forthcoming, they could be allocated losses in line with the distribution of losses in insolvency, in return for senior claims on or equity in the CCP. The majority of respondents felt that the appropriate NCWO counterfactual for non-default losses was the liquidation of the CCP under national insolvency law after the application of any loss allocation arrangements.

Other respondents asserted that non-default losses should be allocated in proportion to responsibility or control; for example, if clearing members are able to dictate the CCP's investment decisions and/or gain from the benefits, they could bear the risks and costs (though none proposed a specific method or tool for this). Similarly, they asserted that where the non-default loss risk is under the control of the CCP, then it is right for it to be borne by the CCP.

Some respondents argued that CCPs should have prefunded resources at a central bank or similar institution to cover non-default losses and the replenishment of its guarantee fund.

Powers relating to non-default losses are addressed in Sections 2 and 4 of the Guidance including cash calls and powers to write down, where appropriate, unsecured liabilities in accordance with the creditor hierarchy in insolvency.

7. Application of the "no creditor worse off" (NCWO) safeguard

Regarding non-default losses, this was the area of most consensus, with the large majority of respondents saying the counterfactual should either be liquidation of the CCP under national insolvency law, or liquidation of the CCP under national insolvency law following the application of any loss allocation arrangements.

For default losses, there were a wide range of views as regards the counterfactual. These included: liquidation in insolvency (because the resolution authority should only step in when recovery has been exhausted); application of the loss allocation rules with no room for deviation; or application of the loss allocation rules with the ability for there to be a financial stability override.

All respondents supported the need for ex ante clarity regarding the counterfactual and formulation of the safeguard.

Several respondents also urged regulators to require that CCPs remove non-recourse provisions from their rulebooks and provide senior debt claims to clearing participants that suffer losses from the application of loss allocation tools utilised after exhaustion of funded (i.e. default fund) and unfunded (i.e. capped assessments) mutualised resources and position allocation tools. This, they argued, would enable clearing participants to benefit from NCWO protection.

The Guidance addresses the 'no creditor worse off' safeguard for both default losses and non-default losses in Section 5. The counterfactual should assume the full application of the CCP's rules and arrangements and any other contractual agreements subject to the applicable insolvency law. It notes that the counterfactual underlying the NCWO safeguard should be clear and transparent for both default and non-default loss scenarios.

8. Equity exchange in resolution

Some respondents supported the full write down of CCP capital upon entry into resolution. Others rejected this, in particular for default losses offering reasons including that the CCP does not cause but only 'receives' these losses, and that it would undermine incentives in recovery especially in the case of intervention before the end of the waterfall and recovery tools. For non-default losses, they were more accepting that capital may be written down, though again some drew a distinction between losses that were under the control of the CCP, and those that were not.

Some respondents stated that participants should receive senior debt claims, following the use of PTU and VMGH for default losses, and any loss allocation for non-default losses and that these claims could be converted to equity in resolution to recapitalise the CCP. Others strongly rejected this, due to the distortion to recovery incentives.

Section 4 of the Guidance addresses the allocation of losses to equity holders. It states that in resolution, equity should be fully loss absorbing. It should be clear and transparent at which point in resolution any remaining equity would be written down. Resolution authorities may also consider alternative approaches to allocating losses to existing equity holders and

recapitalising the CCP.

9. Adequacy of financial resources in resolution

The majority of respondents did not support the idea of requiring additional prefunded resources for resolution from default losses. The most common reasons given were the inefficiency of holding such resources for beyond extreme but plausible circumstances, and the risk of disrupting incentives to support recovery.

A small number of respondents, however, were open to some prefunded resources. Some suggested resources could be prefunded or pre-committed and held specifically for recapitalisation purposes. Few supported external resolution funds.

One respondent called for explicit government support tools. Otherwise all respondents accepted the principle of avoiding losses to taxpayers.

Section 6 of the Guidance notes that, as part of resolution planning, the resolution authority should make appropriately prudent assumptions about the financial resources that may be required to achieve the resolution objectives and the resources that it expects to remain available under the CCP's rules and arrangements at the time of entry into resolution.

The FSB will continue its work on financial resources for CCP resolution and, based on further analysis and experience gained in resolution planning, determine by end-2018 whether there is a need for any additional guidance.

10. Cross-border cooperation

All respondents supported the need to have strong cross-border coordination for CCP resolution planning and execution, but were clear about the need to ensure the home resolution authority was in the lead and had the ability to act quickly in crisis.

There was strong support for close coordination between supervisors and resolution authorities, including in the recovery phase, as well as engagement with the authorities of large clearing members. Some noted the need for balance to ensure Crisis Management Groups (CMGs) are practical and efficient.

Section 9 of the Guidance addresses CMGs and engagement with relevant host authorities from jurisdictions where a CCP is systemically important but that are not represented on the CMG.

11. Cross-border effectiveness of resolution actions

Most respondents welcomed these sections of the discussion note and emphasised the importance of effective cross-border resolution actions, but without offering detailed comments. Many respondents recommended regular cross-border stress testing and fire drills as part of resolution planning. Also mentioned were the treatment of foreign participants, licences and authorisations, and interoperability and other links between CCPs.

Section 10 of the Guidance sets out a number of considerations in relation to cross-border effectiveness and enforcement of resolution actions.

12. Suspension of central clearing mandates

There were mixed responses on the suspension of central clearing mandates. Some strongly supported having a power to suspend central clearing mandates on an expedited basis in the event of a CCP resolution, especially where there are few or no viable alternative clearing venues.

Others were not convinced of the usefulness of this action in a CCP resolution. Some questioned the practical aspects of this, particular where clearing mandates are determined by another authority; or another jurisdiction; or require changes to legislation (or regulatory forbearance) to take effect. Others questioned whether it would in fact be helpful to the resolution objectives, as the underlying causes such as lack of liquidity/activity in the mandated products may be better addressed by suspending trading rather than suspending the clearing mandate. Aside from being difficult to enact, a suspension may be unhelpful in the CCP's efforts to return to a matched book and encouraged continued use of critical clearing services. A few responses set out specific scenarios where a suspension could be an appropriate tool.

Section 10 of the Guidance notes that where relevant to the CCP, resolution authorities should ensure that they have in place appropriate communication and information sharing arrangements with the relevant domestic and foreign authorities that are competent for setting and suspending clearing mandates.