FSB FINANCIAL STABILITY BOARD

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Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution

Overview of responses to the consultation

1. Introduction

On 4 May 2020, the FSB published a consultative document on guidance on financial resources to support central counterparty (CCP) resolution and on the treatment of CCP equity in resolution.[1] The following provides an overview of the responses received to the consultation.[2]

In addition, the FSB Cross-Border Crisis Management Group for Financial Market Infrastructures (fmiCBCM) held two virtual outreach events on the draft guidance on 25 and 30 June. Participants included representatives of CCPs, clearing members, buy-side firms, legal experts and academia as well as public authorities. The Annex includes a summary of the discussions in the outreach events.

2. General comments

The majority of respondents welcomed the public consultation and the effort to provide more detailed guidance on CCP resolution to promote financial stability. Respondents expressed support for the focus on systemic risk and the aim to ensure that taxpayers are not exposed to losses. Respondents also stressed that resilience, recovery and resolvability are closely interlinked and welcomed the close cooperation between the FSB and the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO).

Many respondents expressed the view that clearer policy was needed on some issues. In this regard, the Chairs of the FSB, CPMI, IOSCO and of the FSB Resolution Steering Group propose to collaborate on and conduct further work on CCP financial resources through their respective committees. Such work will consider during the course of 2021 the need for, and develop as appropriate, international policy on the use, composition and amount of financial resources in recovery and resolution to further strengthen the resilience and resolvability of CCPs in default

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1 FSB, *Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution: Consultative document*

2 The public responses (18) are available on the FSB website.

and non-default loss scenarios. This would include assessing whether any new types of pre-funded resources would be necessary to enhance CCP resolvability.[3]

This guidance aims at assisting resolution authorities in applying the existing principles incorporated in the Key Attributes (KA), the FMI Annex and the FSB 2017 guidance. It also gives resolution authorities a construct for approaching these challenges, refining strategies and considering potential risks and trade-offs in resolution. Resolution authorities' experience in applying this construct will help inform any future adjustments to this guidance. As such, the FSB considers the guidance a highly worthwhile addition to the policy framework around CCP resilience and resolvability, notwithstanding the need for the further policy work outlined above.

Reflecting the call by some respondents for the FSB to review the guidance earlier than in five years, the FSB now commits to review the guidance at the latest in five years after its publication. The final timetable will be informed by authorities' feedback on the use of the guidance and any additional resolution related policy work that may be undertaken (see section 2.1.).

2.1. Comments on policy matters

Some comments related to matters that are outside the scope of the guidance. These included requests for the FSB to engage with central banks on matters relating to the provision of central bank liquidity and requests to limit central clearing to certain types of products, with transitional arrangements for new products.

Some other comments called for additional work to be undertaken on both resilience and recovery and resolution. Such broader comments, which partially fall outside the FSB's responsibility, included requests to:

- Develop requirements on the amount of equity a CCP is required to hold and how equity would be required to cover losses in recovery and resolution;
- Determine how default and non-default losses should be allocated between the CCP and clearing members/participants;
- Distinguish between the "operational" and "financial" resources of a CCP;
- Introduce caps on the use of loss-absorbing resources (cash calls, variation margin gains haircutting (VMGH) and partial tear-ups (PTUs)) from market participants in recovery and resolution to diminish their pro-cyclical and market destabilising effect;
- Develop governance arrangements for the use of certain tools (particularly VMGH and PTUs) in recovery and resolution; and
- Further facilitate enhanced cooperation between CCP supervisory and resolution authorities, particularly across crisis management groups (CMGs).

[3] See *FSB releases guidance on CCP financial resources for resolution and announces further work*.

Comments were also received advocating new types of prefunded resources for CCP resolution, such as bail-inable bonds, as well as proposals for new types of powers for the resolution authority, such as the ability to suspend clearing.

3. Part I: Financial resources to support CCP resolution

3.1. Step 1: Scenarios

Several respondents thought that the draft guidance prescribed extreme and implausible scenarios, the use of which would be inconsistent with current international standards and would risk upsetting central clearing incentives. On the other hand, some other respondents supported the FSB's view that the circumstances leading to a CCP resolution are likely to be beyond the extreme but plausible market conditions for which a CCP should hold sufficient prefunded financial resources. In line with this, the FSB is of the view that it is prudent for resolution authorities to consider resolution scenarios that go beyond the extreme but plausible scenarios used in recovery planning. Therefore, no changes have been made to the proposed scenarios in the guidance.

Several respondents urged the FSB to clarify that the guidance would not eliminate local authorities' flexibility to consider resolution scenarios adapted to their local environment, CCP and jurisdiction and to contemplate additional ones not identified in the FSB's guidance. While the guidance aims at converging the authorities' approaches to resolution planning, resolution authorities should apply it in a manner best suited to the resolution planning of the CCPs under their responsibility. The wording has been clarified accordingly.

Several respondents commented that certain scenarios (1.1(ii), 1.1(iii), 1.2(ii)) are unlikely, because they would mean that the CCP's arrangements would not comply with the Principles for Financial Market Infrastructures (PFMI) or the CCP's rules. Many also considered the scenario where the CCP's shareholders would not support the CCP's recovery phase to be extremely unlikely. The FSB considers that the scenarios are appropriate to foster the resolution-related analysis required for resolution planning purposes. No changes have been made to the guidance.

Several respondents considered that the resolution authority should not initiate resolution, before the tools and resources defined in the CCP's rulebook and recovery plan have been utilised in full or financial stability is likely to be compromised (see scenarios 1.1(iv) and 1.2(v)), referring to the criteria set out in the FSB 2017 Guidance. The FSB emphasises that the intention of the two scenarios is not to amend the criteria for entry into resolution set out in Section 3 of the FSB 2017 Guidance. As such, the FSB considers that the above scenarios are helpful to illustrate a core resolution challenge on which resolution authorities can focus. No changes have therefore been made to these scenarios.

Several respondents had understood that the discussion on non-default loss (NDL) scenarios in Section 1.2 aimed at allocating the responsibility for covering all NDLs to the CCP. Respondents particularly opposed a presumption where a CCP would need to cover the losses arising from the failure of a custodian or settlement bank. The FSB notes that the intention was not to take a view on this matter. The drafting has been clarified accordingly.

One respondent considered that it would have been useful to include examples of combined default and non-default loss scenarios in the guidance. Another respondent stressed that a clear distinction between default and non-default losses is not achievable. The FSB agrees that focusing on additional scenarios and their combinations is useful but thinks that it is important to add additional layers of complexity only over time.

3.2. Step 2: Evaluating existing resources and tools

Several respondents supported the references to specific types of products cleared and CCP ownership structure as points that the resolution authority should consider when evaluating the existing resources and tools and suggested further elaborating these points. The FSB does not consider that there is a need to include additional details, given the need for the guidance to be suitable for all types of CCPs operating under different legal and regulatory frameworks.

Another respondent noted that the objectives of maintaining a CCP's critical functions and avoiding exposing taxpayers to losses should be highlighted before the other key points to give them higher importance. Reflecting this comment, and the fact that some of the issues listed were already covered in the FSB 2017 Guidance, the points in the final guidance have been reorganised, without making any changes of substance.

A few respondents suggested that resolution authorities, in coordination and cooperation with the relevant CCP supervisory and oversight authorities, should also test the resolution plans and playbooks regularly and that the testing should also cover the interplay with the default management and recovery stages. The FSB agrees with the importance of adequately testing the resolution plans. Reflecting this, Step 2 of the guidance now notes that the resolution authority may also consider developing resolution playbooks, and conducting crisis simulation exercises in coordination with other authorities, to understand the practicality and feasibility of the resolution plan.

Some respondents urged the FSB to note that a CCP's financial resources should be assessed on a standalone basis without considering the resources of any parent company or affiliates. The FSB considers that this matter does not lend itself to be addressed in this guidance that focuses on assisting resolution authorities in applying the existing FSB standards and guidance. No changes have therefore been made.

Respondents made several comments on the resources and tools listed in sections 2.1 (for default loss scenarios) and 2.2 (for non-default loss scenarios) of the draft guidance. The FSB emphasises that the guidance is not intended to express a view on which resources and tools should be available for CCP resolution in each jurisdiction, how their use should be regulated, or which resources and tools would be the most suitable ones in the case of a resolution of a particular CCP. Instead, the objective is to provide resolution authorities guidance on the matters to consider when they evaluate each resource or tool available to them to help them determine whether they have a reasonable resolution strategy that meets the KA or whether changes (for example to strategy, tools or powers) are needed. The drafting has been clarified accordingly.

Reflecting some comments, the impact of certain tools on various participants has been included as an additional consideration. This assessment is important in the context of understanding the financial stability impact of each resource and tool.

One respondent requested the references to clearing members in Section 2.2.3 to be extended to other participants. The reference to clearing members has been maintained, in line with FSB 2017 Guidance.

3.3. Step 3: Assessing resolution costs

The respondents had limited comments on Step 3. Some suggested that the FSB guidance could also tackle which costs should be considered in a potential insolvency and how they should be estimated and calculated. While the FSB understands the benefits of such guidance, insolvency matters fall under national legislation and are outside the scope of the KA and FSB resolution guidance.

A minor drafting clarification has been made to address the comment by one respondent relating to the administrative costs of the resolution authority. This is intended to clarify that such costs would relate to the resolution of the CCP, rather than include all the administrative costs of the resolution authority.

3.4. Step 4: Identifying gaps

The respondents generally agreed with the FSB's analysis in this section. However, reflecting the comment made by one respondent, a reference has been added to the need to identify not only gaps in resources, but also any underlying reasons for such gaps (e.g. insufficient margin model in a particular scenario).

One respondent proposed that the FSB focus on a more conceptual, qualitative analysis instead of the current detailed analysis. Another respondent criticised the FSB's approach because in its view the FSB tries to compare quantifiable resources with future unmeasurable costs. The FSB recognises that this type of detailed analysis that aims to measure the gap is challenging, but considers that it is still beneficial for a resolution authority to undertake such structured analysis.

3.5. Step 5: Evaluating means to address gaps

Comments on this section related primarily to general policy matters that are discussed above in section 2.1. In addition, many respondents argued that initial margin should not be used for resolution. In their view, any CCP that would utilise initial margin haircutting (IMH) would be vulnerable to runs. The FSB recognises that IMH has significant disadvantages and individual jurisdictions may have restrictions or prohibitions for its use. However, there is a need to maintain the references to bankruptcy remote initial margin in the guidance for consistency with Sections 4.10 and 4.11 of the FMI Annex to the KA, which are not amended through this guidance.

4. Part II: Treatment of equity

The comments on Part II reflected diverging views between respondents on the extent to which CCP equity should (or should not) be exposed to additional losses in resolution beyond the prefunded CCP equity dedicated to cover losses as part of the default waterfall (skin in the game (SITG)). Some proposals from respondents representing clearing participants related not only

to resolution, but also to business as usual and recovery. Matters not related to resolution fall outside the FSB's area of responsibility. Such proposals included:

- Applying the CCP's residual capital (funds that are held to support the CCP's day-to-day operations, outside the default waterfall) in recovery to absorb outstanding losses; and
- Setting SITG to a percentage of the full default fund and/or linked to the default fund contribution of the largest clearing members.

Some respondents representing clearing participants were also of the view that CCPs should be required to modify rules and implement structures that would enable compliance with the KA. This aspect is already addressed under section 7(i) of the guidance.

A suggestion was also made that the FSB should require jurisdictions to change or clarify laws, including the applicable insolvency law, to ensure that the no creditor worse off than in liquidation (NCWOL) safeguard would not be applicable to CCP equity. In this regard, the guidance already urges the relevant home authorities to address the challenges relating to CCP equity fully bearing losses which may include, among other measures, identifying or proposing changes to laws that would enable limiting the potential for NCWOL claims.

On the other hand, respondents representing CCPs and their associations argued that the use of a CCP's equity in resolution, including where it is used as compensation to participants that contributed to a recovery or resolution, reduces incentives for market participants to appropriately manage their risks and actively participate in the default management process and recovery efforts, thus promoting CCP resolution over recovery.

As mentioned above, the objective of the current guidance is not to provide new FSB policy (or revise the existing policy) on the treatment of CCP equity in resolution. Instead, the guidance aims at assisting resolution authorities in applying the existing principles incorporated in the KA, the FMI Annex and the FSB 2017 guidance.

4.1. NCWOL safeguard

Many respondents commented on the discussion on the NCWOL safeguard in the context of the treatment of equity. In many cases, the comments appeared to reflect the nature of the legal frameworks in the respondents' jurisdictions. Some respondents argued that in their jurisdictions equity holders would never have the right to compensation under the NCWOL safeguard, whereas some other respondents noted that the inappropriate use of CCP equity in resolution could give rise to NCWOL claims by CCP equity holders in their jurisdictions.

Reflecting the potential differences in legal regimes, one respondent encouraged the FSB to assess concrete cases of NCWOL claims risks, based on specific legal analyses in FSB jurisdictions before providing any guidance on the issue. Another respondent was of the view that the FSB should remove the references to NCWOL from the guidance, as it only applies to creditors and not equity holders, or explain more fully the relevance of the concept to the treatment of equity.

In addition, some respondents commented on the factors and circumstances that should be taken into account when determining whether a creditor is worse off in resolution than in liquidation. Points made included:

- The need to consider factors likely to be present in liquidation, such as how volatile markets could be if clearing services were disrupted;
- The need to reflect the impact of terminating clearing services on clearing members and CCP shareholders, such as the need for clearing members to replace their contracts and the loss of the value of the CCP shareholders' shares;
- The need to consider as part of the NCWOL counterfactual the losses and costs to clearing members and their clients of closing the CCP; and
- The need to assume the exercise of closeout netting against the CCP in accordance with its closeout netting rule when determining the counterfactual.

The guidance has now been clarified to refer to insolvency regimes applicable in each jurisdiction. It has also been noted that the NCWOL safeguard may apply differently in different jurisdictions.

4.2. Compensation

Regarding compensation, the respondents representing participants:

- Argued that compensation should be provided to clearing members and end-users for all losses incurred as a result of default fund assessments, VMGH, or PTUs, whether during recovery or in resolution.
- Proposed that clearing participants that suffer losses from the use of recovery or resolution tools (beyond the loss absorbing resources) should receive as compensation instruments that are not debt, but senior to CCP equity that would provide holders of these instruments a claim to the future income of the CCP.

On the other hand, CCP respondents:

- Considered that compensating clearing members with equity or claims on future earnings disincentivises clearing members' active participation in the default management process, provides a diminished incentive for clearing members to bid for the defaulted portfolio and discourages a private recapitalisation of the CCP.
- Disagreed with the principle of compensating clearing members for tools utilised as a part of CCP recovery and resolution, particularly with equity in the CCP, beyond what is provided under the NCWOL safeguard, since compensation for other motives would expose public funds (when the resolution authority takes over the CCP).

Based on the comments made, the guidance has been clarified to include in the resolution authority's considerations for compensating clearing members: (i) the circumstances in which compensation may be appropriate and potential implications of any compensation; and (ii)

potential mechanisms for such compensation. The revised guidance now also refers to all possible compensation instruments mentioned in the FSB 2017 Guidance (equity, other instruments of ownership, or debt instruments convertible to equity).

Annex: Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution

Summary of virtual outreach events on 25 and 30 June 2020

On 25 and 30 June 2020, the FSB Cross-Border Crisis Management Group for Financial Market Infrastructures (fmiCBCM) held two virtual outreach events on the draft guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution, published for consultation on 4 May 2020. The objective of the events was to ensure that the proposal was well understood by stakeholders and to receive initial feedback on the draft guidance. Participants included representatives of CCPs, clearing members, buy-side firms, legal experts and academia as well as public authorities. The events were chaired by fmiCBCM co-chairs María José Gómez Yubero and Ricardo Delfin.

The 25 June session covered Part I of the draft guidance that covers the evaluation of existing resources, tools and costs in possible resolution scenarios, the identification of gaps in resources and tools and the evaluation of means to address such gaps. The 30 June session was devoted to Part II, addressing the treatment of equity in resolution plans and possible mechanisms for adjusting, and implementing policy for, the treatment of CCP equity in resolution. The discussions each day consisted of two panels of participants that addressed the questions posed in the consultative document and included comments and questions from other participants. The events were held under the Chatham House Rule.

1. Financial resources to support CCP resolution

In general, participants agreed that the process outlined in the draft guidance would provide an effective tool for assessing the adequacy of financial resources and tools to be used in resolution.

1.1. Step 1: Scenarios

A range of views were provided on the scenarios. One participant called for additional granularity for the default loss (DL) scenarios, notably by "putting numbers" to potential market movements and financial losses in extreme market scenarios.

One participant argued that the concurrent materialisation of DL and NDL scenarios may also warrant further consideration, noting that the party in control of the risk should be the one bearing any resulting losses, and that clearing members have no or very limited influence over how the CCP mitigates most NDL risks. To this, another participant responded that DL and NDL scenarios may often overlap, and getting into a debate during a crisis about loss allocation based on this distinction would not be useful.

Some participants argued that third-party measures to limit the systemic risk implications of a CCP resolution event may warrant further consideration in the scenario design, given that in view of their broader contagion risks CCP resolution events would likely call into action other public authorities beyond CCP resolution authorities. Other participants argued that it would be

difficult to anticipate and model such actions, given their discretionary nature as well as potentially different approaches across affected jurisdictions.

Several participants argued that the development of playbooks and the conduct of crisis simulation exercises may be helpful in further developing credible resolution scenarios, although it would never be possible to capture all potential real-life events.

1.2. Step 2: Resources and tools

Some participants emphasised that the financial resource requirements should be established in such a manner that they incentivise clearing members' active participation in default management.

Some participants indicated that clearing members should not be held liable for an unlimited or undefined amount. A suggestion was made to limit additional cash calls to the size of the default fund, and subject further cash calls to a ballot of the members. Some participants were of the view that clearing members must receive compensation for additional cash calls, VMGH and PTUs by making them recoverable through the future profits of a revived CCP or from prioritised payouts from a resolved CCP.

A participant argued that it would be important to differentiate between loss allocation tools and financing tools. CCP rulebooks should determine the allocation of losses between the CCP and clearing members. Any other tools should be considered financing tools. This should particularly apply to VMGH for the use of which end investors would need to be refunded. Absent such refunding, end investors would run which would have financial stability consequences.

Some participants emphasised the challenge in resolution arising from CCP rules that are designed to increase CCP resilience by allocating losses to clearing members and requiring them to provide additional liquidity resources to the CCP. In resolution, however, these rules result in leaving some or all of the CCP equity intact, while creditors' (clearing members and their clients') claims may be extinguished before NCWOL protection is established. Some participants also expressed concern about the potential significant resource implications and resulting uncertainty of post-resolution litigation.

A participant advocated that regulators should look more at the liquidity and volatility of centrally cleared products. He argued that mandatory central clearing should be limited to sufficiently liquid products to enhance CCP resolvability. CCP shareholders should also fully backstop new products until the products are sufficiently liquid and can become backed by the default fund.

Some participants argued that they would rather be exposed through higher costs for central clearing ex ante by contributing to enhanced prefunding requirements rather than being confronted with potentially large and unpredictable payment obligations at the point of resolution.

1.3. Step 3: Costs

Some participants recognised the difficulty of estimating resolution costs, including the administrative costs of the resolution authority. Some suggested that legal or regulatory changes might be needed in each jurisdiction to increase legal certainty for such costs.

Some participants stressed the importance of playbooks and simulation exercises also for quantifying resolution costs. Joint stress tests between authorities e.g. in CMGs could in their view enhance resolution planning. One participant noted that an easy to understand playbook is beneficial for efficient discussions under stress.

1.4. Steps 4 and 5: Gaps

One participant emphasised the importance of the powers of the resolution authority. Useful powers would include the ability to access liquidity support from the central bank and a regulatory authority over the CCP's parent company. Another participant suggested focusing on analysing the resolution authority's powers, informed by the scenarios, rather than conducting the rigid analysis required by the draft guidance. Following this logic, Steps 4 and 5 could focus on legal and operational shortfalls and their impact on financial shortfalls.

2. Treatment of equity

Participants discussed multiple aspects relating to the treatment of CCP equity in resolution, including how equity is treated in recovery and liquidation and the financial stability impact of the timing and sequencing of imposing losses on CCP equity. In the view of several participants, the treatment of CCP equity is part of a broader set of issues relating to loss allocation in CCP recovery and resolution.

Against this background, some participants were of the view that the current loss allocation structures are not sufficient to deal with the misaligned incentives between "super systemic" CCPs and clearing members. They also pointed to the potential moral hazard and financial stability risks the current contract-based arrangements may create. In their view it would be important to have clear rules and transparency about how losses are allocated in both recovery and resolution, including a clear statutory "pecking order" for using resources to maintain critical functions. One participant also called for a clear definition of when a CCP is "failing or likely to fail" and resolution could be initiated.

Some participants also urged the FSB to develop more detailed requirements for a CCP resolution regime and the tools available to resolution authorities to address the risks on an ex ante basis. They called for CCPs to be subject to higher capital requirements and have ex ante recapitalisation resources in the form of bail-inable bonds. One participant proposed that the value of such bonds could be based on the slow moving average of open interest at the CCP. Such bonds could be offered first to the owners of the CCP and then to clearing members.

Some participants argued that changing the current treatment of CCP equity would undermine financial stability and likely violate the NCWOL safeguard. Some emphasised that in the case of default losses, restoring a matched book is paramount and clearing members should be the ones primarily responsible for contributing to recovery and resolution.

Some participants also argued that CCPs should not cover NDLs that arise from the failure of an entity (such as a settlement bank or a custodian) that is itself subject to a resolution regime. Expecting such NDLs to be covered by CCP equity would in their view effectively require the CCP to become the guarantor of the financial system. On the other hand, another participant

noted that in a NDL scenario, where the matched book could be transferred, CCP equity should bear losses, since shareholders bear responsibility for the CCP's operational risk management.

Some participants emphasised that complying with the KA requirement for CCP equity to be fully loss-absorbing is critical. They were of the view that the guidance should be amended to avoid implicitly accepting deviations from this requirement. Rather than accepting any legal limitations to equity bearing losses in resolution, resolution authorities should in their view require CCPs to modify their rules and loss allocation structures to enable compliance with the KA. In their view, the NCWOL safeguard was created to protect similarly situated creditors, not equity holders.

One participant noted that while CCP equity needs to be maintained for regulatory compliance, existing shareholders do not need to be protected. Further, the guidance should not create the impression that shareholders are treated as creditors under all jurisdictions' legal frameworks. Another participant noted that the CCP equity (SITG) in the default waterfall should in fact not be qualified as equity for the purposes of the resolution authority's powers. It should rather be treated as assets needed by the CCP to provide its credit risk mitigation services.

One participant considered that Section 8 of the draft guidance, as currently drafted, reads as trying to justify why equity would not need to absorb losses first, which does not seem to be in line with the KA. In terms of more specific comments, one participant noted that it is not for the resolution authority to consider the effect of CCP resolution on the CCP's group entities; instead, the groups should structure themselves to comply with the resolution regime. Another participant emphasised the importance of considering how CCP shareholders are interconnected to assess the impact of CCP equity covering losses in resolution.

Several participants were of the view that a statement in the resolvability assessment process on any limitations to equity bearing losses would not be helpful. On the contrary, it could signal that equity may be treated differently in resolution from recovery and may thereby only increase systemic risk. Some participants also warned against using transparency as a compromise to justify lack of action in reforming CCP resolution regimes to provide for equity bearing losses in resolution.