

BME CLEARING RESPONSE TO FSB CONSULTATIVE DOCUMENT: "GUIDANCE ON FINANCIAL RESOURCES TO SUPPORT CCP RESOLUTION AND ON THE TREATMENT OF CCP EQUITY IN RESOLUTION"

INTRODUCTION

BME CLEARING provides central counterparty services in Spain. BME CLEARING has been authorized in accordance with the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012, on OTC derivatives, central counterparties and trade repositories (EMIR). In accordance with EMIR, BME CLEARING has received, on 16 September 2014, the authorization of its competent authority, the Comisión Nacional del Mercado de Valores (CNMV), to provide clearing services as a Qualified Central Counterparty (QCCP).

BME CLEARING is therefore included in the list of CCPs authorized to offer services and activities in the European Union, published by the European Securities and Markets Authority (ESMA).

BME CLEARING runs the Central Counterparty (CCP) under the following segments:

- Financial Derivatives
- Public Debt Repos
- Energy Derivatives
- Interest Rate Swaps
- Equity

BME CLEARING would like to thank the opportunity to give its views on the FSB Consultative document about "Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution".

BME CLEARING is a member of the European Association of CCP Clearing Houses (EACH), which has also produced a response to the FSB consultation paper. BME CLEARING supports the EACH response and this individual response intends to highlight BME CLEARING's points of view on certain topics.

It is important to make several preliminary considerations before responding to the consultation paper questions.

As explained in the first paragraph of the introduction of the Consultative document, and in any reasoning on the interest of public policy and supervision on the financial resources available to support CCP resolution, it is all related to the central clearing of OTC derivatives and the obligation to centrally clear such derivatives that emerged from the reforms agreed by the G20 Leaders. That obligation brought CCPs to the front line of concerns like systemic risk and the risk of having to be supported with taxpayers money. But, notably, there is no mention at all in the consultation or in any paper on the matter, about Exchange Traded Derivatives (ETD) or securities (stocks and bonds) transactions cleared by CCPs prior to their settlement. These two activities, particularly the clearing of ETDs, have been the main activity of the CCPs for years, the CCPs have performed brilliantly through all the severe crisis of the last 40 years. Because of that, when the need to centrally clear OTC derivatives arose, the service was built around or using the same infrastructures that had so solidly managed all the crisis, self-containing any default occurred and avoiding by far any systemic spread and any recourse to public aid.

The bulk of OTC derivatives relates to interest rates, credit derivatives, and, though generally not centrally cleared, FX derivatives. CCP service offerings are housed in pre-existing CCPs but with a different risk profile, segregated and ring-fenced from the risks of the ETD and securities clearing services. Nevertheless, public policy and supervision seems to ignore the big difference in operation and risk profiles between those two types of activities (OTC derivatives clearing versus ETD and securities clearing), only because they are performed by the same CCPs. But the fact is that many CCPs have negligible or none activity in the OTC derivatives space.

The new activity to centrally clear OTC derivatives has meant a great amount of bilateral and perhaps unmeasured exposures have moved into the CCP space. While this move represents an improvement in the resilience of the whole system due to the safeguards that come with centralized clearing, it inevitably shows that CCPs role is increased and possibly stressed, but it is relevant to note that the increase in exposures for CCPs has not been evenly distributed, with the majority of the move to central clearing of OTC derivatives going to a few giant CCPs (and even then within specific ring-fenced segments) while smaller (and some larger) CCPs have continued their usual business in ETD or securities clearing without any additional reason to have concerns about their capacity to cope with a stressed scenario.

It would be convenient to match the policies and the supervision with the concerns, an analysis that does not differentiate these two worlds would very likely be incomplete. We miss some proportionality in the approach when referring to CCPs, the few CCPs that operate in the world are very different in size and in their involvement with OTC derivatives, and very few are really systemic at a continental or global level.

In Annex I we provide a list of the Initial Margin (IM) required by the main CCPs operating in Europe as of 31-03-2020, with data obtained from CPMI-IOSCO PQD. There are a few CCPs missing but those on the list represent nearly 100% of the market.

The list includes: Eurex Clearing, LCH Ltd, LCH SA, CC&G, Nasdaq Clearing, EuroCCP, ICE Clear Europe, ECC, SIX x-clear and BME CLEARING. It is 10 CCPs. In terms of IM, the top 4 represent 93% of the total. The largest CCP is 107 times the smallest.

Below, we can see that 52% of all IM is related to OTC derivatives, but this is the most concentrated IM as it is held in only four CCPs, one holding 86% of the total.

Clearing of	IM euro million	
OTC derivatives	216,758	52%*
Securities	69,030	17%
ETDs	129,042	31%
TOTAL	414,829	

*Only four CCPs contribute meaningfully to this figure, with one representing 86%

On the subject of proportionality and systemic importance, we can look at BME CLEARING's case, its IM is just 0.7% of the total in Europe. BME CLEARING instruments are practically all national securities and ETDs on national underlying assets; the only non-domestic instruments cleared are the OTC IR swaps denominated in Euro, the positions are so small that the IM is 9 million euro, out of the 2,793 million euro of the CCP. Naturally the domestic instruments are used by international players but the size in the overall picture remains small. If one of the smallest CCPs like BME CLEARING is considered systemically important in more than one jurisdiction (SI>1), the sheer concept of systemic importance must be reconsidered.

Please see Annex 1 for further quantitative information.

PART I. FINANCIAL RESOURCES FOR CCP RESOLUTION

Step 1: Scenarios

Q1. What are your views on the scenarios presented for evaluating existing tools and resources?

BME CLEARING agrees with the scenarios presented to be considered by the resolution authorities in the recovery planning exercise. We welcome the fact that some of the proposals made in the Consultation process that took place in 2018 have been taken into consideration. In particular, we appreciate that the failure to comply with CPMI-IOSCO principles or with other mandatory legal regimes enforceable to CCPs has not been included as a workable scenario.

Additionally, we would like to point out the following remarks on some scenarios.

We see that in both types of scenarios, default and non-default losses, one of the possible scenarios is that the relevant authorities determine that resolution should be initiated before some of the recovery arrangements or tools are applied or the CCP is wound down.

We would like to insist that in line with the general comment outlined above, resolution of the CCP should only occur after the exhaustion of recovery tools. For that reason, those scenarios both for default losses and non-default losses, although theoretically possible, should be avoided.

Applying the full recovery plan must be a priority in order to preserve the incentives scheme for clearing members. This would contribute to the continuity of the critical services provided by the CCP and would result in greater financial stability (e.g. to avoid a contagion effect across multiple CCPs).

We also would like to bring into consideration the suspension of clearing mandates, as an event which can lead to the resolution of a CCP or as a resolution tool to be used by Resolution Authorities. In our view it would be interesting to assess and explain such possibilities. We believe that the suspension of clearing mandates could limit the will of clearing members to participate in the recovery process and therefore, we would appreciate a clarification on its terms in a resolution situation.

We would like to insist in one of the statements we made in the previous consultation, in 2018: in our view, loss allocation for non-default losses should be proportional to the level of responsibility, risk and/or benefits derived from the service for each stakeholder, including not only the CCP, but also clearing members and other CCP users, in its case.

In particular, potential losses arising from investment risks could even be borne exclusively by participants when, according to the CCP rules and regulations, they are granted the decision of the investment and the benefits obtained with such investment, as is the case of BME CLEARING.

This principle of responsibility of NDL between CCP and its participants should be mirrored in the resolution planning by authorities.

We would also like to suggest that the resolution authorities use a risk approach when assessing the resources needed in the case of non-default losses. Besides, we would like to remind that in the European Union jurisdiction, CCPs have very specific and restrictive capital requirements in EMIR RTS 152/2013 to address operational and legal risk, credit counterparty, market and business-related risks. In our view, and as stated by EACH, *"a proposal to increase the CCPs' equity for NDL is not necessarily the answer: there are other remedies than equity that would be much more adequate (e.g. for liquidity shortfalls, investment losses, legal risks, failure of a custodian or settlement platform, failure of a concentration bank, central banks action or non-performance of vendors, service providers and IT suppliers).*

Adding equity on top of this would jeopardise the economics of clearing by imposing excessive fees that would discourage the use of CCPs' services and trigger a return to the bilateral world. The 2017 paper provides quantitative evidence that that 'there is not much scope for a CCP to carry "dead capital" before it would start returning less than the cost of equity and would discourage private capital from funding the CCP."

Lastly, we would like to make some remarks on the proposed non-default scenario where the CCP's shareholders do not support the CCP's recovery actions, whether or not there is a contractual commitment, a parental guarantee or a similar agreement to provide financial resources.

In BME CLEARING's view, this situation should only be taken as a feasible scenario when there is a previous formalized commitment from the CCP's shareholders or its parent company. As far as default losses are concerned, it is critical that no resolution tools in general, equity write-downs in particular, be permitted until a CCP exhausts all available recovery tools and clearing members meet all of their obligations to participate in the recovery measures. Besides, resolution tools should be considered with regards to the CCP as an isolated entity, with no recourse to parent or affiliate entities' financial resources or guarantees, in order to avoid risk of contagion, especially where other critical services are provided by different companies in the same group. The possibility of requiring parent companies contractually

agreed guarantees, as a source of additional financial resources for the resolution of the CCP, would hinder the main purpose to avoid contagion. Moreover, this requirement could digress the general mercantile principle of limitation of liability to equity.

Q2. Are there additional considerations that should be included in the guidance?

We believe that it would be very useful if the FSB could provide with examples or a more detailed explanation on the combination of default and non-default scenarios.

Furthermore, in our view it is key that the resolution authorities keep the flexibility to adapt the scenarios described in the FSB Guidelines to their local jurisdiction and the context and characteristics of the CCP.

BME CLEARING would also like to recollect the rationale exposed in the response to the 2018 consultation: according to the current CCPs business model, CCPs equity should not be taken as the basis in a resolution situation so as to deal with the risk brought by its members. CCPs equity roughly accounts for approximately 1% of the CCPs Initial Margins and 10% of the Default Fund (these are very rough averages). CCPs operators are far from being big companies such as other financial institutions and imposing additional financial resource obligations on CCPs could have negative effects on the clearing ecosystem. Having to prefund a greater amount of capital would lead to the need to change the business model by dramatically increasing clearing fees (to provide a reasonable ROE), which in the end could result in a disincentive to clearing, where clearing is optional. CCPs own contributions, SITG, as they are currently sized, are enough to complete the incentives scheme.

Step 2: Evaluating existing resources and tools

Q3. Are the qualitative and quantitative considerations for evaluating existing resources and tools comprehensive and sufficiently clear?

In our view, the qualitative and quantitative considerations for evaluating existing resources and tools are comprehensive and sufficiently clear.

As previously stated, we particularly welcome that there is a reference to the need for resolution authorities to assess the specificities of certain types of products cleared and the potential impact on stakeholders incentives to support recovery or resolution, including clearing members. We also appreciate the reference to the importance of maintaining continuity of critical functions which should be seen as an objective in itself.

BME CLEARING would like to add the following remarks.

First of all, we think it would be useful to highlight the importance of certain issues, which are essential from our point of view and constitute the basis for this type of analysis, such as the maintenance of the continuity of critical functions and the need to avoid exposing taxpayers to costs.

Besides, resolution tools should be considered with regards to the CCP as an isolated entity, with no recourse to parent or affiliate entities' financial resources or guarantees, in order to avoid risk of

contagion, especially where other critical services are provided by different companies in the same group.

The resolution authority should take into account that insurance policies to cover non-default risks of the CCP are not mandatory. More importantly, their availability and the extent of their coverage to cover non-default risks of the CCP is a very complex issue.

BME CLEARING welcomes the reference to the contractual agreements for allocating non-default losses to clearing members. We agree that every stakeholder should be considered in the allocation of non-default losses, according to their level of responsibility, the risk taken and the benefits they derive from the service: the owner of the CCP and its users (clearing members and others).

Finally, referring in particular to the conversion of creditor claims into equity to recapitalize the CCP, resolution authorities should consider the fact that CCP shareholders are subject to suitability requirements, that should prevail even in a resolution event. This circumstance could lead to a potential different treatment over the creditors, based on suitability considerations, and not in mercantile ones, that may result in an undesirable different treatment of creditors.

Q4. Are there additional considerations that should be included in the evaluation?

The document mentions the statutory powers of the resolution authority, both for default losses and non-default losses scenarios. In our view, this issue should be further explained, in order to clarify all the possible interactions between such statutory powers and the CCP Rules. Moreover, the possible implications of the exercise of the statutory powers on the NCWOL, should be clarified as well.

Step 3. Assessing potential resolution costs

Q5. Are the considerations for analysing resolution costs comprehensive and sufficiently clear?

In BME CLEARING's view, it would be very useful to have further advice on the losses that might have to be covered by the available resources, especially in the case of default losses, as for non-default losses calculation the document states, at least, some criteria for its determination.

Losses to be considered should be those remaining after the recovery measures are applied by the CCP. The resources available in resolution should neither include the initial margins of the CCP nor its recovery tools.

It is important to point out that initial margins are (even at legal level in a good number of jurisdictions) exclusively aimed at covering the risk deriving from the cleared products and are not part of the own resources of the CCP available for resolution, regardless of the way of posting them. They can only be used to cover the losses resulting from the closing-out of the position of the defaulting participants.

Regarding the administrative cost of the resolution authority, we would like to point out that they should be limited to the extraordinary administrative costs borne by the resolution authority but not to current expenses such as salary payments.

Q6. Are there any other resolution costs that should be addressed?

We believe that it would be extremely useful to have a guidance on the costs that an insolvency process would generate, in order to properly assess NCWOL risks.

Step 4. Comparing existing resources and tools to resolution cost and identifying any gaps

Q7. What are your views on the considerations for resolution authorities when they identify gaps in resources and tools?

It is essential that the resolution authority makes a different assessment than the CCP in the recovery phase: they should not consider recovery tools, as there are differences as regards resources, available tools and resolution costs. Any additional tools to be considered in resolution should be different to the ones reserved to recovery and should be subject to an independent assessment by the resolution authority. If the recovery and resolution tools overlap, there is a danger that the resolution of the CCP will be precipitated, without giving the opportunity for the recovery stage to succeed.

Q8. Are there additional considerations that should be included in the guidance?

In our view, it is key that the resolution authority allows sufficient time for the deployment and implementation of the recovery plan until the resources and tools provided for in the recovery plan and the CCP regulations have been fully exhausted.

Although the resolution authority may fear that a late intervention may reduce the effectiveness of the resolution, it is assumed that the resolution plan was designed taking into account the risk management and recovery plan by the CCP and to ensure that the resolution plan does not affect potential successful recovery by the CCP.

In case the resolution authority intervenes before the exhaustion of the CCP's recovery plan, it must be convinced of the need for its intervention based on financial stability considerations and even be able to prove and demonstrate it with sufficient evidence.

Q9. Are there any specific steps or approaches you would suggest that authorities consider as part of quantitative analyses?

We believe that the resolution authority should take into account the type of products cleared by the CCP, in terms of the risk that they could imply. As previously explained in the introductory section of this response, we want to emphasise the need to differentiate ETDs and securities from OTC derivative products

and their level of concentration. We also miss some proportionality in the approach when referring to CCPs, the few CCPs that operate in the world are very different in size and in their involvement with OTC derivatives, and very few are really systemic at a continental or global level.

Step 5. Evaluating the availability, costs and benefits of potential means of addressing any identified gaps

Q10. What are your views on the consideration for evaluating the availability, costs and benefits of potential means to address identified credit or liquidity gaps?

BME CLEARING agrees with the considerations for evaluating the availability, costs and benefits of potential means to address identified credit or liquidity gaps included in the consultation document.

Nevertheless, we would like to point out that greater costs and expenses could result in an undesirable disincentive effect on central clearing.

Q11. Are there additional suggestions for potential steps to address identified credit or liquidity gaps that should be included in the guidance?

We believe that CCP's regulatory capital should always be respected in a resolution situation, in order to maintain the continuity of its critical functions and the incentives scheme. If the authorisation to provide clearing services is in danger, clearing members and stakeholders will be highly discouraged to participate in the process.

Moreover, it is necessary to bear in mind the possible raise in the cost of central clearing: if CCPs are required to increase their financial resources without a rationale it would result in the already mentioned undesirable disincentive effect on central clearing.

PART II. TREATMENT OF CCP EQUITY IN RESOLUTION

Q12. Are the considerations for addressing the treatment of CCP equity in resolution plans sufficiently clear?

BME CLEARING agrees that the considerations for addressing the treatment of CCP equity in resolution plans are sufficiently clear.

We understand that Resolution Authorities should not be limited in the use of the most appropriate resolution tool by the application of the No Creditor Worse Off in Liquidation (NCWOL) safeguard. We would like to stress the importance of a further clarification of the counterfactual concept: the value of the continuity of the CCP clearing services is very high for Clearing Members, and it should be considered as part of the counterfactual. This remark in the NCWOL counterfactual would limit possible ex-post claims against Resolution Authorities.

Moreover, as we mentioned in the response to the public consultation of the FSB Discussion Paper of 15th November 2018, we would like to highlight that legal certainty is key and consequently bankruptcy and insolvency national laws must be perfectly matched with the regime of CCPs resolution.

Q13. Are there additional factors that resolution authorities should consider when evaluating the exposure of CCP equity to losses in resolution?

From our point of view, the factors considered when evaluating the exposure of CCP equity to losses in resolution are sufficient.

Q14. Are there additional mechanisms that could be used for adjusting the exposure of CCP equity to losses in resolution that should be included in the guidance?

BME CLEARING would like to recall one of our key points mentioned in our response to the previous FSB consultation, in 2018. We see with concern the possibility of granting inadequate compensations, which would result in the breach of the incentives scheme in the recovery and resolution phases. CCPs have an incentive structure which ensures that all clearing participants are committed to contribute to the continuity of the CCP avoiding resolution. Any type of compensation in the resolution phase would harm such incentive scheme: the fact that clearing participants might have the opportunity to be compensated during resolution could prevent them from participating in the regular default waterfall process or in the use of the recovery tools contained in the CCP recovery plan or in its Internal Regulations. For that reason, it does not seem adequate to compensate clearing members for their participation in cash calls or VMGH raised outside CCP's rules.

These type of compensation could harm CCPs business model, and result in a discouragement to operate a CCP. CCPs would be required to compensate clearing members for mutual losses, and this, would provoke a failing of the CCP's stake in the business. Furthermore, it would be an incentive for the clearing members to seek a decrease of their contribution under the CCP rules in order to reduce their potential losses and, at the same time, to increase the possibility of being compensated. As previously mentioned, the CCPs incentives scheme commits participants to contribute and participate in the default waterfall and the recovery plan in the interest of of the continuity of the service.

We would like to point out the implications with the NCWOL as this type of compensations could increase the probability of the resolution authorities receiving claims from clearing members: any divergence between the tools used by the resolution authority and the CCPs rulebook or its Recovery Plan could lead to claims. This, in the end, could result in having to recur to public funds, which is, in our view totally undesirable.

Lastly, it is important to acknowledge that the entire financial system takes advantage of the continuity of clearing services.

Q15. Within the section on implementing policy for the treatment of CCP equity in resolution, are there additional items that the relevant home authorities should consider?

The items to be considered by the relevant home authorities seem adequate to BME CLEARING for the treatment of CCP equity in resolution.

We would like to highlight that in the European jurisdiction CCP shareholders always bear losses, and therefore, it would be very rare that resolution authorities received a claim from the CCP shareholders.

As previously mentioned, it is important for the relevant home authorities to assess if any tool aimed at ensuring that equity fully bears losses in resolution would be appropriate in terms of the impact on CCP management incentives, on stakeholders incentives to support recovery and avoid resolution, impact on continuity of critical services and on different business models and legal structures of CCPs.

Q16. Would a statement in the resolvability assessment process on any limitations to equity bearing losses provide sufficient transparency for stakeholders? How could sufficient transparency be achieved?

We believe that any limitations to equity bearing losses should be specified in the resolvability assessment process. Moreover, the resolution plans should include such statement.

ANNEX 1

CPMI-IOSCO Data as of 31/03/2020 (in € million)

CCP	Segment	Original Currency reported	IM - Section 6.1.1 IOSCO (million euro)
LCH Ltd	Equities	GBP	3.976,18
	Fixed Income Securities	EUR	7.117,59
	FX	USD	4.818,16
	IRS (SwapClear)	GBP	182.127,71
	Total	GBP	198.039,65
EUREX CLEARING	Equity Derivatives	EUR	49.960,34
	Fixed Income Derivatives	EUR	10.563,04
	OTC IRS	EUR	18.178,58
	Commodities	EUR	9,45
	Precious Metals	EUR	140,70
	FX	EUR	491,71
	MSCI Dividend Futures	EUR	0,30
	Asian Cooperations KOSPI/TAIFEX	EUR	3,66
	Corporate Bonds	EUR	0,00
	Derivatives on Fixed Income ETFs	EUR	13,66
	Remaining Products	EUR	8.190,78
	Total	EUR	87.552,24
ICE CLEAR EUROPE	Derivatives	USD	47.579,47
	CDS	EUR	6.715,19
	Total	USD	54.294,66
LCH, S.A.	Cash and Derivatives	EUR	10.170,30
	Fixed Income Securities	EUR	30.697,02
	OTC_CDS	EUR	4.908,67
	€GC Plus	EUR	260,15
	Total	EUR	46.036,14
CC&G	Cash and Derivatives	EUR	3.226,51
	Fixed Income Securities	EUR	11.280,45
	Energy	EUR	0,41
	Commodities	EUR	0,00
	Total	EUR	14.507,37
NASDAQ CLEARING	Derivatives	SEK	3.501,92
	Commodities	EUR	1.137,82
	Seafood	NOK	20,70
	Total	SEK	4.660,44
ECC	Total	EUR	2.801,70

BME CLEARING	Derivatives	EUR	1.651,95
	Fixed Income Securities	EUR	614,86
	Energy	EUR	131,73
	IRS	EUR	9,34
	Equities	EUR	384,94
	Total	EUR	2.792,83
EUROCCP	Total	EUR	2.308,09
SIX X-CLEAR	Cash Markets	CHF	1.596,44
	Derivatives	NOK	239,82
	Total	CHF	1.836,26