

Via E-Mail (FSB@fsb.org)

17 October 2016

Financial Stability Board
Bank for International Settlements
CH-4002 Basel, Switzerland

RE: Essential Aspects of CCP Resolution Planning – Discussion Note

Dear Board Members:

CCP12 is a global association of 35 major central counterparty (“CCP”) organisations in Europe, Asia and the Americas. CCP12 was formed to share information, develop analyses and develop policy standards for common areas of concern. CCP12 members work toward the common purpose of creating conditions in which a global CCP solution can emerge to meet the needs of the marketplace.

This letter represents our response to the discussion note published by the Financial Stability Board (“FSB”) *Essential Aspects of CCP Resolution Planning*. CCP12 appreciates the active engagement of the FSB in on-going discussions on this topic, particularly the roundtable in September that allowed our members to gain further insight into the Board’s concerns. We further appreciate the opportunity to provide these written comments to the FSB.

Overview

In developing a resolution plan, it is critical that the respective resolution authorities (“RAs”), in consultation with regulators and CCPs, understand the circumstances and market scenarios that could push the CCP to such an extreme point. Most likely, a CCP will only face a resolution scenario if multiple large, highly capitalised clearing members have defaulted simultaneously or if it incurs non-default losses of such magnitude that it would threaten the CCP’s solvency. This would be an unprecedented scenario that, by definition, would be beyond extreme but plausible as defined by the regulators. Whilst we agree that it is crucial to have plans in place to address this possibility in order to ensure the continuity of critical clearing services, we believe that regulators and market participants recognise how extreme a situation must be to arrive as such losses. For this reason, we believe that proportionality should be the key principle driving the definition of a Resolution framework for CCPs.

The extraordinary circumstances of such an event mean that neither CCPs nor regulators will be able to fully plan for every hypothetical scenario. The extreme and unprecedented nature of a situation that could place a CCP in recovery will require that CCPs have access to all of the tools in the toolbox to determine which steps to take given the facts and circumstances at the time of the event. As described by the CFTC guidance on Recovery Plans and Wind-down Plans,¹ flexibility in this approach should be supported by significant analysis and transparency in defining the necessary rules:

¹ <http://www.cftc.gov/PressRoom/PressReleases/pr7409-16>

While each [recovery] scenario event will, almost inevitably, involve unique and unforeseen circumstances that will require a certain degree of flexibility in the DCO's approach to addressing that event, DCR believes that maintaining an established and carefully considered recovery toolkit to guide its recovery efforts will result in the ability to react to an unexpected event more rapidly; provide transparency to clearing members and other participants; and assist in ensuring that the Rules, policies and procedures necessary to implement the recovery tools are in place.

Appropriate flexibility for CCP in defining and executing, where available, their recovery plan will be essential to ensuring the CCP can continue offering clearing services.

Given the exceptional nature of such an event, the market will require as much certainty as is possible in executing the tools necessary to restore market stability. This is best achieved by allowing the CCP to execute its recovery plans, which include tools that have been developed using the guidance provided by CPMI IOSCO's *Recovery of financial markets infrastructures* report in consultation with their clearing members and reviewed by the appropriate regulators. Recovery tools are defined in the CCP's rulebook and are crucial to clearing members and market participants to enable them to measure, manage and control their exposures to the CCP during a severe market stress. Resolution should only be triggered if it is necessary to provide for continuity of clearing services and market stability once recovery measures are exhausted.

In addition to providing certainty to the markets, allowing the CCP to execute its recovery tools will also ensure that existing incentive structures are maintained throughout recovery. CCPs operate on the basis of mutual benefits and shared risk between itself, its members, and the end users. These incentives support the CCP function and if these are broken, the risk mitigation benefits of the CCP will be jeopardised. In particular during the extreme and uncertain scenario that could drive a CCP to use its recovery tools, the certainty and reliability of these incentives will be crucial to returning to normal market function.

The core CCP incentives are built into the design of the default management and recovery plans, which ensure that each tool is increasingly uncomfortable for all participants, including CCPs. This is meant to guarantee that all participants have sufficient motivation to participate in the current step in the plan and stabilise the situation as soon as possible. If resolution plans offer a significant reward at the end of the plan, such as a path to clearing member ownership of the CCP or compensation, this will skew the incentive structure of the plans by building a meaningful benefit for clearing members if the CCP goes into resolution. If clearing members have a clear, pre-determined path to ownership of the CCP, they may consider controlling the CCP to be more commercially beneficial than participating in the default management process, ultimately negating the incentives necessary to ensure a successful CCP recovery.

Additionally, it may be that defining compensation for any stage of recovery could encourage industry participants to lobby for reducing the layers of risk management prior to recovery, to more quickly reach the point at which they will receive compensation. This would result in a shorter default waterfall and fewer resources available to manage a default situation before a CCP is in recovery, jeopardising risk management principles. It also weakens the contractual obligations agreed to by clearing members who have signed on to the CCP, which includes the mutualisation of losses.

As the industry prepares for this kind of extreme hypothetical event, there is an understandable desire to increase funding and require significantly more money to be held by clearing members and CCPs to protect against this risk. However, any increase to funding will ultimately increase the cost of clearing for all users. This could create additional pressure on clearing members, making it more expensive to offer client clearing and making it more difficult for smaller clients to access cleared services. The industry has already seen a significant drop in the number of clearing members offering client clearing,² and ESMA's recent proposal to postpone clearing mandates on smaller financial firms indicated the detrimental effect of the growing cost of clearing on smaller firms.³ Any decision to increase funding, must balance the need for increased security with the impact of the increase the cost of clearing.

Response to Specific Questions

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

We recognise the challenge of designing strategies for the sort of hypothetical tail-of-tail events that would lead to a CCP resolution and we appreciate the efforts by the FSB to outline the problem and are committed to working with regulators and the industry to find solutions under these extreme scenarios. We appreciate the opportunity to comment on the proposals.

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 normal times, CCPs operate as a market intermediary, facilitating and enforcing settlement of payments for their members without issue. In the case of default losses where multiple clearing members have defaulted to the clearinghouse, the most likely scenario that would push a CCP into resolution, CCP operations will be even more crucial to the on-going health and stability of the market, but the strain on the market and our members will make those processes more challenging. To ensure participants in our markets will meet their obligations and work toward the greater good of the market, CCPs have developed a series of incentives and penalties to encourage behaviour that is more likely to bring markets back into alignment. These incentive structures, codified in the CCP rulebook and member agreements, are widely understood and accepted by the market, which will rely on the certainty of these processes during this severe market stress.

In order for these processes to operate as designed, the CCP must be left to execute its recovery plan to the fullest extent possible. On the whole, there is broad agreement across the industry that a CCP-led recovery is preferable for the broader market and preserving, to the greatest degree possible, the certainty and service continuity necessary to ensure a quick return to stable markets. Early intervention by the RA could create a greater disruption, potentially propagating market instability unnecessarily. Early intervention could also challenge existing legal certainty with regards

² <https://www.clarusft.com/fcm-rankings-q1-2016/>

³ https://www.esma.europa.eu/sites/default/files/library/2016-1125_cp_on_clearing_obligation_for_financial_counterparties.pdf

to the responsibilities of the CCP board and senior management unless the transfer of legal responsibilities and decision making obligations to the RA are clearly delineated.

The CCP should be given an opportunity to run its regulator-reviewed recovery plan, which will include incentives to encourage clearing participants' behaviour towards promoting CCP recovery. Without these incentives, participant behaviour may not align with the interests of the broader market and the CCP recovery necessary to return to stability. Presumption of early resolution or early intervention of the RA could undermine recovery efforts if the known incentive structure is skewed or if clearing members determine that resolution would be in their best interests.

The incentives created by the CCP in its recovery plan are designed to ensure active participation of clearing members in the default management process. As this situation is most likely the result of multiple members defaulting to the CCP, restoration of a matched book is the most crucial step in returning to market stability. Until the defaulters' positions can be moved off of the CCP's books – through auction or, worst case scenario, partial contract tear up – the CCP cannot return to a matched book and losses stemming from the portfolio will persist. Without participation from clearing members and participants, CCPs cannot guarantee a successful auction of the defaulters' positions. Skewing the incentives, through early intervention or the presumption of early intervention by the RA, will jeopardise the success of the auction and create the risk of a continued unmatched book and lingering losses.

The incentives defined in the CCP rulebook and default management plan are part of the membership agreements for clearing members. These firms have signed up with the CCP and explicitly agreed to participate in the default management process or suffer the consequences defined in the rulebook and plans. These consequences must be sufficiently burdensome to ensure clearing members are properly incentivised to participate in the process. Existing incentives meet market needs while avoiding perverse incentives that would encourage clearing members to allow the recovery to fail. As they have already signed up to abide by these rules and be subject to these plans, clearing members are fully aware of their obligations and requirements under these circumstances and can reasonably be expected to understand their potential liabilities.

Additional Incentives

Given the severity of the scenario that could lead to a CCP resolution, it might seem appropriate to consider additional incentives to manage the situation. However, in designing these incentives, it is important to focus on CCP recovery and avoid a situation where clearing members may be incentivised to allow recovery to fail due to benefits they may receive in resolution. Mechanisms that would lead to the distribution of CCP equity, in particular, could create an environment where clearing members view the benefit of taking an ownership stake in a CCP as greater than the sunk costs already suffered during the default management process, as we'll describe in greater detail in Q18.

We do believe that there may be a benefit from creating additional incentives in the recovery and default management process, provided such benefits do not perverse the incentives for CCP recovery. Specifically, incentives should encourage clearing members to actively participate in the default management process which will help return the CCP to a matched book and avoid the use of extreme recovery tools. Some CCPs have already implemented a "juniorisation" process to identify poor bidders in the auction and ensure their mutualised default fund contributions are used ahead

of members who bid well in the auction. This creates incentives to actively bid and work toward market stability.

However, we acknowledge that other regulatory requirements may make the prospect of winning a bid or taking on client accounts overly burdensome for clearing members who would otherwise be eager to participate. Temporary relief from regulatory capital requirements for clearing members that provide good bids and actively participate in default management and client porting processes could help incentivise good behaviour and secure prompt transition for clients of the defaulted clearing members. This would also alleviate risk of procyclical requirements, caused by the risk of increases in collateral and capital requirements for clearing members that win defaulters' positions and/or accept client accounts.

As CCP12 has described in previous consultations,⁴ the leverage ratio as defined under Basel III will increase for clearing members that accept clients through porting, due to the inability to offset margin held for these exposures. Temporary relief from these capital requirements will allow clearing members to accept ported client positions and defaulter positions without suffering an immediate capital squeeze; even temporary relief will help return to a matched book with clients at active members in the immediate aftermath of the defaults, providing crucial time to market participants to work through any short-term issues that may have prevented them from participating in default management.

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?*

We agree with the statement in 3.6, that it is “difficult to make an exact presumption in advance about the timing of entry into resolution.” Authorities should avoid the presumption of resolution for CCPs. Creating a defined limit to the CCP’s recovery plan could arbitrarily truncate the recovery process before the recovery plan has had the opportunity to work properly. This will limit participation in the plan and prevent clearing members from actively engaging in the default management process, creating an environment where recovery plans are believed to have failed and resolution becomes more likely even for CCPs that would otherwise be able to recover from the stress.

That said, it is crucial to ensure that the authorities have the ability to intervene and put a CCP into recovery if it feels that such actions are necessary and in the best interests of the broader market. Nothing in these recommendations is meant to suggest that such powers should not be at the authorities’ disposal should it become necessary.

In the event of a multiple clearing member defaults, the authorities will be informed immediately (or, more likely, prior to the CCP declaring the defaults), and will be updated throughout the process. This is to ensure the authorities have proper oversight over the process as it develops so they are

⁴ <https://ccp12site-main.pbworks.com/w/file/109356655/CCP12-EACH%20Response%20Revisions%20to%20the%20Basel%20III%20LeverageRatioFramework.pdf>

able to determine next steps if their involvement becomes necessary. Whilst we believe a non-default loss scenario is far less likely to push a CCP to recovery or resolution, the resolution authority must maintain similar rights to oversight and intervention if it becomes necessary. This early oversight of the CCP's default management and recovery process, rather than defined intervention, will allow the authorities to coordinate with the CCP and participants to minimise disruptions to the market and ensure a prompt return to market stability.

In evaluating the recovery process, timing of entry into resolution should be dependent on the stress scenario threatening the viability of the CCP and the circumstances at the CCP at that time, as well as the CCP's handling of the situation. CCPs should be entered into resolution only if their recovery plans have failed or it is determined that the recovery tools would dramatically increase market instability and are unlikely to be successful. Given that this situation represents an unprecedented market event, there is no way to predict the exact stress scenario that the CCP will be facing or the tools that will be best used in that scenario. Just as the CCP needs flexibility in defining its recovery plan and, where available, in addressing the specific stress scenario, flexibility is needed in declaring resolution to ensure the steps taken are appropriate for the circumstance at the time.

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?

Decisions about pre-funding should consider first what funds already exist, as well as the goal and potential impact of additional pre-funded resources.

Existing Resources

CCPs are subject to significant regulation regarding their funding and are held accountable for maintaining appropriate levels pre-funded resources to meet a variety of needs. This includes the regulatory requirement to maintain sufficient funds to effect an orderly wind-down, typically measured as six months of operating costs,⁵ which regulators have determined is sufficient for closing or transferring the CCPs critical businesses. This funding would be relied upon for general business and non-default losses, in addition to any jurisdictional-specific regulations that CCPs may be subject to for protection against investment, liquidity, and operational losses.

To address default losses, CCPs maintain sufficient pre-funded financial resources as defined by their regulatory requirements to the address the default of their largest clearing members, an unprecedented stress situation. CCPs also supply a significant layer of funding in the default waterfall, in line with regulatory requirements, where applicable.

Whilst all of these are pre-funded, they serve very different purposes in a CCP recovery. Specifically, there are meaningful differences between the clearing member funded mutualised pool and the CCP funded layer ("skin in the game" or "SIG"). The mutualised pool is meant to cover the losses of simultaneous, unprecedented defaults and provides incentives to clearing members to participate in the default process to avoid compromising their contribution to the pool.

⁵ See 3.15.5 <http://www.bis.org/cpmi/publ/d101a.pdf>

CCP SIG on the other hand is meant to ensure appropriate alignment of incentives between the CCP operators and the CCP users and should be sized to properly supplement the existing CCP incentives, taking into account relevant regulatory standards, the CCP's market risk-neutral position, and the CCP's business interests. SIG can help encourage the use of a CCP's clearing services as a result of the CCP's sound risk management policies and procedures. As the first loss after the defaulters' funding is exhausted, CCPs are incentivised to limit the impact of losses beyond the defaulters' contributions; in doing so, CCPs also limit or prevent any impact to non-defaulting clearing members. This is an appropriate balance given the risk neutral position of the CCP and the ability of the clearing members alone to absorb defaulter positions and clients. We can assume that clearing members will consider the CCP's SIG in pricing their bids for the auctions during default management and an overly large SIG will incentivise uncompetitive bidding and create inefficiencies in the market, effectively subsidising the risk of the clearing members. Any additional pre-funding must consider and avoid skewing this balance.

Unfunded Resources

Whilst we appreciate the concern regarding resources that have not been prefunded, it is important to understand that the quantum of resources considered in the unfunded portion of the waterfall is generally much smaller than the amount seen in variation margin payments during stress periods. As clearing members historically have been able to meet their obligations for variation margin, even during periods of significant stress such as the Lehman default and the British referendum, it is reasonable to conclude that the much smaller payment needed to meet their assessment obligations would be available from clearing members.

Additional Resources

Additional resources will impact the incentive structure crucial to successful default management during a severe stress, as described above. Additionally, higher levels of pre-funding will increase costs to all participants, which may not be justified when considering how unlikely it is that the market will suffer from such an event. Requiring prefunded resources reserved for an event that the regulators acknowledge is beyond extreme but plausible is not an effective use of capital and represents a disproportionate cost for tail risk. This would ultimately have the perverse effect of discouraging clearing.

Although some in the industry have argued that increased costs are justified, it is important to keep in mind smaller clearing members and market participants who would be less able to meet increased requirements. As ESMA noted in their proposal to delay the clearing mandate for Category 3 financial counterparties,⁶ increased costs will negatively impact smaller firms and potentially limit their access to clearing services, which they are required to use.

If firms are driven out of the market due to increased costs, cleared markets will become more concentrated among a few large players. This creates challenges in day to day risk management, as most clearing members will be managing massive portfolios. More importantly, this increases the systemic risk of a clearing member default, as there will be fewer participant available to absorb the defaulter's positions and even fewer available to accept client portfolios – client portfolios that will

⁶ https://www.esma.europa.eu/sites/default/files/library/2016-1125_cp_on_clearing_obligation_for_financial_counterparties.pdf

also be larger than normal due to the reduced numbers of clearing members willing to participate in client clearing.

The goal of increased pre-funding is to address an extreme stress scenario, such as the default of multiple large clearing members. This goal would be undercut by the challenges created through increased concentration risk as higher costs drive participants from the market. Any proposal to increase funding for any entity – CCPs or clearing members – must consider participants of all sizes, and the substantial risk of increased concentration among clearing members.

Finally, if there is a concern among members that additionally funding is needed, we see no benefit to establishing and maintaining that funding outside the CCP's pre-funded and unfunded default fund. The total amount of resources available at the CCP is typically publically reported and its adequacy is regularly reviewed by regulators to ensure the CCP's funding remains sufficient to cover extreme but plausible stresses. This ensures that obligations are generally and appropriately distributed across clearing members based on the risk of their portfolio.

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?*

In defining the quantum of any resources, it is critical to ensure the existing incentive structure is not threatened. These incentives are crucial to ensuring successful outcomes for default management and recovery plans and any changes to funding will impact the careful balance designed in the current plans.

Default Losses

The risk of loss must lay with the entity responsible for managing the exposure to the risk; shifting the funding responsibility will result in inappropriate subsidisation of risk, allowing participants to take on more risk than they can support and putting entities with less risky or risk neutral positions at risk of losses beyond what is reasonable. As previously described, CCP's maintain, as a minimum, pre-funded financial resources to cover the default of their largest clearing members, in addition to their own SIG. As clearing members are the only entities that can create default losses, and are the only entities that can absorb the defaulter's portfolio to stop default losses, the responsibility for these losses must lay primarily with clearing members.

Non-Default losses

CCP's maintain insurance and other financial resources to address a variety non-default losses resulting from general, business and operational risks. This includes assets funded by the equity of its owners which is "sufficient to ensure a recovery or orderly wind-down of critical operations and services."⁷ CCPs report their available liquid assets and the amount necessary to ensure on-going operations of the CCP can continue for six months in their quantitative disclosures.⁸ Additional arrangements are generally published in the CCP's additional public disclosures. We believe that this is sufficient funding to ensure adequate safeguards against non-default losses, particularly given the

⁷ See Principle 15 <http://www.bis.org/cpmi/publ/d101a.pdf>

⁸ See point 15 <http://www.bis.org/cpmi/publ/d125.pdf>

amount of transparency provided to the market to allow participants to monitor their risks accordingly.

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?*

Resolution funds external to the CCP should not be relied upon. Establishing such funding arrangements would result in an unreasonable and unnecessary increase to funding requirements for clearing members and end users. It is unlikely that clearing members of all sizes could provide additional pre-funded resources, potentially driving some firms out of the market and creating avoidable concentration risks as smaller clearing members are unable to participate. A concentrated clearing membership will make it more difficult to auction a portfolio or port clients in a default, exacerbating losses and stress in financial markets

Beyond clearing member arrangements, pre-arranged sales of CCP equity in resolution could have negative impacts on CCP's ability to secure facilities or increase the costs of maintaining facilities during business as usual. Again, the potential benefits of such an arrangement must be considered against the extreme unlikelihood of reaching such a tail-of-a-tail event as well as the ultimate cost to all participants to support it.

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 tools used in the resolution must be determined considering the specific facts and circumstances at the time. The most crucial aspect of recovery and resolution is the return to a matched book, which will stem the losses of the defaults and hasten a return to market stability. This process should be left to the CCPs, in the first instance, as they have the necessary experience and expertise in the markets under consideration. If a viable market still exists, this could include on-going auction processes. If, through the auction process, the CCP has identified a particular set of products that are preventing the return to a matched book and there does not exist a viable market or sufficient liquidity in these products, limited partial tear-ups may be an appropriate tool to restore the matched book and preserve the healthy markets served by the CCP. All of the tools available to return to a matched book should be included in a CCP's rulebook and recovery plan.

Though it is not an ideal outcome, partial tear up is an appropriate tool as defined by CPMI-IOSCO.⁹ This tool should be implemented after multiple auction cycles that allow participants with an interest in the market to bid on the defaulter's positions. Frequently, these auctions will include appropriate client firms who express an interest in bidding on the portfolio, ensuring giving the auction the best chance of success. Multiple unsuccessful auctions indicate that there is no longer an appetite for the products in the market. Partial tear ups distributes losses only after reasonable effort has been made to move the positions.

⁹ See 4.5.12 <http://www.bis.org/cpmi/publ/d121.pdf>

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

CCPs have the benefit of day-to-day risk management of the markets impacted by the default of multiple clearing members. The market will not benefit by limiting the tools available to the CCP, who is the best positioned to execute these tools.

The tools should be established by the CCP *ex-ante* to provide members and market participants with clarity on recovery/resolution outcomes. This will also encourage market participants to actively participate in the default management process through strong bids in the auctions for defaulted member positions, rather than face the potential losses caused by the tools needed for extreme scenarios. If the RA steps in, even to execute the tools defined in the CCP rulebook, the market will interpret this as a sign that the CCP has failed. The incentives that the CCP has developed for its recovery processes will be severely impacted and could result in market inefficiencies that slow the return to stable markets.

Whilst we agree that the RA must have the ability to step in if the CCP recovery appears to be unsuccessful or if the tools planned would likely bring greater instability to the market, it should not be assumed that the RA will step in until the CCP recovery plan has been exhausted. As previously discussed, the CCP must be able to execute its recovery plan as designed and reviewed by regulators.

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?*

Effective tools for allocating default losses

There are a variety of tools that we believe will be effective for managing losses in a default situation. These should be implemented by the CCP given the facts and circumstances of the event at the time and cannot be limited to a certain prescribed order.

Margin Gains Haircuts: Margin gains haircutting is powerful tool that can only be used for a limited-time tool to allow the CCP to continue operations for a short time while a known, identified solution is put into place. Recognising that this tool is not appropriate for all CCPs, the regulators and resolution authority will be in consultation prior to executing, if appropriate for the market. This approach could have many benefits, primarily reducing the risk of CCP insolvency and facilitates continuity of clearing service and operations, which we know would bring greater instability to the market. Under gains haircutting, losses are fully allocated across all market participants to minimise the impact to any particular market participant. The market will have continued access to the critical clearing services and operations. Ultimately, gains haircuts allows for additional time to re-establish a matched book, minimising market uncertainty.

Effective tools for allocating non-default losses

The decision of whether and how to allocate non-default losses should be based on the facts and circumstances of the non-default scenario. There are a variety of non-default scenarios that could

potentially lead to losses at the CCP and, while they are unlikely to lead to a CCP recovery or resolution or threaten the CCP's solvency, they will require unique tools to manage. The principle used in determining how to allocate non-default losses should focus on which entity is ultimately responsible for making the decisions that contributed to the losses. For example, if investments directed by the clearing member lead to losses, it is reasonable to expect that they would participate in some of the losses. On the other hand, where the CCP maintains total control over the decisions, the liability should lie with the CCP.

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)?*

CCPs have the benefit of day-to-day risk management of the markets impacted by the default of multiple clearing members. The market will not benefit by limiting the tools available to the CCP, who is the best positioned to execute these tools. If the RA steps in, even to execute the tools defined in the CCP rulebook, it will skew the incentives developed by the CCP in its recovery and resolution plans, potentially resulting in market inefficiencies that slow the return to stable markets.

Whilst we agree that the RA must have the ability to step in if the CCP recovery appears to be unsuccessful or if the tools planned would likely bring greater instability to the market, it should not be assumed that the RA will step in until the CCP recovery plan has been exhausted. As previously discussed, the CCP must be able to execute its recovery plan as designed and reviewed by regulators. exempt

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?*

Transparency and predictability of tools is crucial to ensure clearing members understand the risks and losses they may face in a stress scenario. In the default waterfall, the steps that will be taken by the CCP and participants, as well as the order in which they will be taken and exact triggers to execute each, are clearly defined in the CCP's rulebook. Additionally, CCPs will have included the appropriate authorities in the execution of the default management process, ensuring both supervisory and resolution authorities have full transparency into the CCP's approach and fully understand the impact of the tools on the wider market. If the default management process is unsuccessful, the authorities will be fully informed of the steps taken and the tools and funding still available as the CCP enters into the recovery process.

To address recovery, the CCP should define the available recovery tools ex ante in their rulebook and recovery plan. However, the exact order and manner to apply these tools may be determined based on the specifics of an unprecedented and extreme scenario, if such flexibility is permitted in the CCP rulebook and recovery plan. Having been involved since the beginning of the default management process, the RA will have full insight into the actions taken by the CCP, the potential next steps of the CCP, and the resources still available.

Unless the CCP recovery has failed, we assume the RA will step into a CCP in recovery to execute tools that were either unavailable to the CCP or not contemplated by the CCP in its recovery plan, as necessary to support stability of the market. Unless the CCP has not executed its recovery plan effectively, the recovery plan has failed, or the RA, with its broader view of the financial markets, believes that the recovery tools to be executed will lead to greater instability for participants, we do not believe it is necessary for the RA to step in. This means that any involvement from the RA will likely deviate from the CCP rules; otherwise it should be assumed that the CCP will execute the tools as defined in their recovery plan.

There are specific instances where the principle of *pari passu* may be suspended, for example in the default management process to allow the CCP to apply specific incentives to ensure active auction participation from clearing members. In some circumstances it may be appropriate to suspend *pari passu* where necessary to create appropriate incentives, provided there is sufficient oversight and consultation from the necessary authorities, as when reviewing the CCP default management process rules. As these tools will be used to create incentives for participants, their application and potential risks will be fully transparent to all participants.

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:*

The preferred approach of the resolution authority to allocating losses

The nature and order of loss allocation should be codified in the CCP's rulebook and should be strictly followed. In defining the recovery and resolution plans, the CCP and RA should have the flexibility to create tools that will work for their markets. The preferred approach for applying recovery tools may be based on the facts and circumstances of the stress event, where available, within the CCP's predefined set of tools. However the preferred approach to allocating losses should follow the hierarchy of loss allocation defined in the CCP's recovery plan. As the RA will likely have access to tools beyond what the CCP can implement, such as additional cash calls, it is important that these tools follow the existing loss allocation hierarchy.

(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?

We assume that if the RA has stepped into the CCP, it is to execute tools for loss allocation that are unique to what the CCP has planned or is able to perform. However, the loss allocation hierarchy defined in the CCP's recovery plan and rulebook should be strictly observed unless deviation is necessary to avoid destabilising effects on the market and all impacted parties are given sufficient notice and transparency into the modified approach.

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?*

As described in Q9, the allocation of losses from a non-default event must be based on the source of the losses and the entity responsible for creating the exposure to that loss. The CCP is generally responsible for non-default losses caused by general business or operational risk, as the CCP is responsible for creating and managing those risks. Where the clearing members have the ability to dictate the exposures, such as choosing investment strategies of their funds or selecting their

custodians, the CCP is only acting under the direct instruction of their clearing members and should not be held accountable for losses associated with these decisions.

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

Aside from loss allocation, the difference between default losses and NDLS will be the type of tools that are applicable.

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?*

We believe NCWO can be structured to give RAs the necessary flexibility to operate appropriately, however, it is 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 may fail.

In considering the counterfactual of NCWO, we consider the guidance provided in Section 8.1 of the FSB paper which suggests that the counterfactual for NCWO should assess the losses that "participants and other creditors would have borne had the authorities not intervened." We interpret this to mean the counterfactual will be the alternative to the loss allocation tools defined in the CCP rulebook and recovery plan. Typically, we have to assume the alternative to the tools is the full wind-down of the CCP. A buyer for the services cannot be assumed and the end result will be a complete tear up of all contracts. Given this, the total risk to creditors must consider the potential for limited, defined loss due to the use of recovery or resolution tools against the significant and multidimensional replacement costs of having to re-establish every position at a new CCP, under the unprecedented market stress expected in the aftermath of a CCP failure.

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

The appropriate NCWO counterfactual for a resolution scenario involving non-default losses would be liquidation under the applicable insolvency regime after any relevant loss allocations arrangements under the CCP’s rulebook.

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

If both a default loss and a non-default loss occur simultaneously, the tools to address them would remain independent, as currently defined in the CCP’s rulebook. The default and non-default losses would be addressed individually with the NCWO counterfactuals described in Q15 and Q16, respectively.

Equity exchange in resolution

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

As discussed in previous answers, the incentive structures designed to manage a default or CCP recovery depend on putting all participants (CCPs and clearing members) at risk of greater loss for lack of participation in the process. Any compensation at the end of the resolution process could result in downward pressure on the CCP's default waterfall and distort the requirements of the clearing members' contractual obligations, while also potentially risking creating perverse incentives that jeopardise the CCP's default management and recovery.

Equity as a compensation tool is extremely likely to skew the incentive structure supporting the CCP's default management and recovery process. Allocating equity to the clearing members effectively creates an ownership opportunity for clearing members in a market stress event. If the CCP is approaching resolution, the clearing member will likely have suffered losses under the default management process. If bearing a relatively small amount of additional losses would result in an ownership stake in the CCP (who may maintain valuable services beyond the clearing service under distress), there is a risk that clearing members would view it as more beneficial to artificially limit their participation in the default management process and encourage the resolution of the CCP to gain this ownership.

Currently, CCPs are structured to ensure independent owners, clearing participants (through the risk committee), and CCP senior management are all incentivised to manage overall risk effectively. The balance created by relying on three groups with independent perspectives ensures that no one voice can overpower the others, resulting in CCP policies that act in the best interest of the market, rather than any individual participant. If one member of that group gains additional power – through clearing members gaining a controlling ownership share of CCP equity – the commercial interests of the clearing members may become overly influential in the CCP risk management processes, resulting in less secure markets coming out of the resolution.

In the event that a CCP operates multiple asset classes with unique clearing memberships, providing an equity stake could threaten the security of the other asset classes. In a situation where one asset class defaults, its clearing members could end up with ownership of the entire CCP. Allowing some clearing members ownership over the entire CCP structure would be an inappropriate result for members of the asset classes that did not suffer losses and may not have signed up to clear at a member-owned clearinghouse.

There is also a risk that this compensation structure favours some clearing members while disincentivising others, who may not be permitted to take an ownership stake in the CCP. There are significant issues with using equity to reward clearing members for behaving in an appropriate manner during a default, recovery, or resolution. Further, the control provided by an equity stake in the CCP is an unnecessary and inappropriate reward for what is generally a financial service.

Cross-border cooperation

Q20. *What are your views on the suggested standing composition of CMGs (Crisis Management Groups)? Should resolution authorities consider inviting additional authorities to the CMG on an ad-hoc basis where this may be appropriate?*

It is crucial that the home authority of the CCP play a leading role in the CMG to manage the CCP's resolution to ensure the idiosyncrasies of the CCP will be properly represented to the CMG. Efficiency and quick responses to the circumstances will be crucial in a CCP resolution. Additionally, it may be valuable to consider an approach that would help avoid duplication of responsibilities for authorities in multiple CMGs for each CCP.

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?*

In disclosing the plans of recovery or resolution strategies, all participants must be cognisant of the risk that providing such detail may skew the incentives for clearing members, jeopardising the likelihood of a successful recovery and exacerbating losses and market stress. Although it may be helpful for the market if authorities disclose the kinds of tools that they will have at their disposal, we believe that the exact order and implementation of the tools must be flexible enough to allow authorities to address the exact stress situation as it unfolds. In general, we believe the market will benefit from "constructive ambiguity", allowing the authorities to respond to the market stress as appropriate given the facts and circumstances at the time, without being bound by a strict, pre-defined plan.

Cross-border effectiveness of resolution actions

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?*

As with all resolution tools, a potential suspension of a clearing mandate could create the risk that clearing members would be encouraged to limit their participation in the processes necessary to ensure a successful CCP recovery. Any change to the mandates must balance this risk with the potential benefits of a suspension of the mandate. Overall, we believe that, if the market is in such a state that the suspension of the clearing mandate is considered, a temporarily closure of the market itself is likely to be more appropriate.

Conclusion

We appreciate the continued efforts of the FSB in working towards a stronger financial system and a sound approach to resolution planning. We appreciate the opportunity to comment on this discussion note and engage in on-going discussion with the FSB. We look forward to continuing to work towards our shared goals of safe, stability markets and customer protections.

Sincerely,



Lee Betsill
Chairman, CCP12