Eurex Clearing Response to the FSB, CPMI-IOSCO and BIS report analysing existing financial resources and tools for CCP recovery and resolution

Frankfurt, 25 April 2022

A) Introductory Remarks

Eurex Clearing is an EMIR authorised central counterparty (CCP) and provides clearing services for cash and derivatives markets in listed and over-the-counter (OTC) financial instruments. Eurex Clearing appreciates the opportunity to provide feedback to the FSB Report 'Central Counterparty Financial Resources for Recovery and Resolution' (hereinafter called 'the report'). Eurex Clearing comments hereby as one of the sampled CCPs in the FSB's analysis.

Eurex Clearing welcomes that the FSB is monitoring the implementation of the FSB guidance on CCP resolution. As a general remark, however, Eurex Clearing would welcome upcoming policy work by the FSB to take into account the different jurisdictional progress made on recovery and resolution frameworks. In this context, Eurex Clearing would like to note that following the international guidance, the EU installed a fully-fledged regime (Regulation (EU) 2021/23 on a framework for the recovery and resolution of central counterparties (CCP Recovery and Resolution Regulation – CCPRRR)) in February 2021 specifying the use, composition and amount of resources and tools available for addressing default and non-default losses in extreme yet plausible scenarios applying to two of the CCPs that were part of the recent analysis. For example, future FSB considerations for further international policy work should ideally reflect that EU CCPs will have to apply a second skin in the game as of early 2023 in both default and non-default events.

With respect to the recent FSB report, Eurex Clearing would like to submit the following comments on the three elements that the FSB analysed:

B) Detailed comments to the report

1. CCP resilience to Default Losses:

Eurex Clearing welcomes the FSB's finding that 'all of the sampled CCPs would have had sufficient prefunded and recovery resources and tools to cover losses in the applied default loss scenarios'.

However, Eurex Clearing agrees that there are limitations to the analysis as acknowledged in the report. In particular, the chosen scenarios were 'significantly more severe than the 'extreme but plausible' standard set out in the PFMI'.

Hence, it is worth highlighting that the assumptions taken for the stress losses calculation in a default event were rather extreme and implausible (Cover 4 with doubled liquidation horizon) compared to the usual CCP calibration (cover-2 in 99.9% confidence level). Considering the extreme scenario, it is an even more positive outcome that CCPs show such strong resilience to default losses.

While there are limitations to these types of quantitative analysis, as outlined in the report, Eurex Clearing concludes from this report that CCPs are very well equipped to withstand financial shocks 'beyond plausible'. Further, Eurex Clearing understands the FSB is confirming our view that CCPs' default-related recovery and resolution tools are sufficient: '[…] *all of the sampled CCPs would have had sufficient prefunded and recovery resources and tools to cover losses in the applied default loss scenarios* […]'.

2. Methodology of calculation of the impact of VMGH

Eurex Clearing notes and welcomes the analysis performed by the FSB on the liquidity risk driven by the usage of VMGH. The report concludes that 'even though at the level of individual bank clearing members the analysis identified only limited impacts on their liquidity and solvency from the use of cash calls and VMGH by an individual CCP, it would be beneficial to enhance as much as possible the understanding of the potential complex system-wide effects of the use of recovery and resolution tools.'
While Eurex Clearing does not consider further policy work necessary on the general recovery and resolution tools, Eurex Clearing agrees with the FSB that better understanding of the implications of using VMGH would be beneficial. In particular, Eurex Clearing is uncertain about the working assumptions and conclusions of the report implying a limited impact of the usage of VMGH. Eurex Clearing would therefore like to ask a few clarifications on some of the hypothesis presented by the FSB and would welcome further analysis to confirm the impact of using VMGH, differentiating it more clearly from other recovery and resolution tools:

Firstly, the statement 'variation margin gains attributable to the non-defaulting clearing members ranged from $189m to $12.5b' supposes that there is a calculable maximum amount that can be drawn by CCPs using VMGH. However, the report also states: 'Market confidence might be damaged if VMGH is used, particularly if it was applied over several days.', implying that there is no limit to the application of VMGH. This assumption is in line with the EU regulation (CCPRRR), which does not foresee any maximum amount or timeframe to VMGH. Given that positive VM has in essence no limits, this raises the question of the methodology the FSB used to determine the maximum amount of VMGH for each CCP/service line.

Further, Eurex Clearing recognises that the analysis summary aggregates the impact of VMGH and assessment calls (graph 3). Eurex Clearing also notes that there is a variation in the impact across Clearing Members (CMs): 'This means that even where the average performance within a bucket would be satisfactory, there could still be liquidity breaches at an individual clearing member level'. Eurex Clearing believes that it would be interesting to analyse the difference of impact between assessment calls and VMGH. VMGH, given that they are proportional to the profits realised at the time of execution on the partial portfolio of the CM or its client, will have an unpredictable distribution in the market. Eurex Clearing understands that individual CM data cannot be shared. This limitation can be circumvented by providing the normalised variance (or standard deviation) of impact of VMGH and assessment calls (separately) within each group. Such data would allow CCPs, in collaboration with their national competent authority and resolution authority, to design the combination of recovery and resolution tools between cash calls and VMGH with the lowest systemic risk.

In addition, Eurex Clearing also observes that the FSB is assessing VMGH in 'conjunction' with the usage of Tear-Up: 'VMGH has the potential to address losses comprehensively, specifically when used in conjunction with a partial tear-up'. As correctly stated by the FSB: 'Partial and complete tear-ups, and forced allocation, are tools to restore a matched book, rather than allocate a loss'. In contrast, VMGH is a loss allocation mechanism. Eurex Clearing is therefore unclear on what 'used in conjunction' means. Eurex clearing sees these two tools as serving different, unrelated purposes: VMGH absorbs excessive losses after the liquidation is performed, while Partial Tear-Up (PTU) resolves a failed liquidation. While they could, coincidently be used sequentially, Eurex Clearing does not perceive these tools as interacting. Additionally, the scenario where there would still be remaining losses after the use of PTU for all major asset classes (and after the use of cash calls) which would need to be covered by VMGH is rather remote, if not implausible.

Lastly, Eurex Clearing agrees with the statement of the FSB that VMGH might impact end users: '[…] the amount of the loss and how clearing members and, where relevant, clients […]'. As mentioned above Eurex Clearing considers VMGH as a powerful tool for absorbing losses, however, it represents a risk since its distribution is very uneven and unpredictable. While VMGH is not applicable to all asset classes and products, its use may result in additional losses to the already losing party. It may therefore impact all market participants, including disproportionately end users, irrespective of the asset class where losses are incurred. Eurex Clearing acknowledges the difficulty of assessing the concrete impact on the clients, as it highly depends on the Clearing Agreement between the CM and the client (some may or may not have "look-through" clauses for VMGH), and that data are difficult to obtain. Eurex Clearing would however welcome such analysis, should the FSB manage to access the relevant information. This effect is not present for assessment calls, as they directly relate to the default fund, which is a prerogative of the CMs.

Eurex Clearing has previously expressed its general concerns regarding the significant caveats of VMGH when answering the CPSS/IOSCO consultation on the matter.[1] The arguments expressed in Eurex Clearing's consultation-response remain generally valid in addition to the comments provided above. Due to the above-mentioned implications of using VMGH, Eurex Clearing considers this tool rather as a last resort, which may be more appropriate in resolution than in the recovery phase.

3. Non-default losses (NDL):

Eurex Clearing appreciates that the FSB acknowledges the limitations of its assumption and analysis and agree with the FSB that the most significant limitation of the NDL analysis was that the results greatly depend on the 'choice of scenarios'. Eurex Clearing therefore believes that the results (i.e., that only through the use of resolution tools sufficient resources would have been mobilised to address the NDLs) should be read with caution, especially from the second hypothetical scenario (cyber theft).

In particular, the cyber theft scenario was designed on an abstract level due to a lack of 'actual experience' with such a case and without detailed guidance as to how CCPs should interpret the given scenario. As one of the sampled CCPs, Eurex Clearing would be interested in how those CCPs that covered the losses with their recovery tools, have interpreted the given scenario. Based on Eurex Clearing's interpretation of the available guidance on the exercise,

[1] https://www.iosco.org/library/pubdocs/418/pdf/Eurex%20Clearing.pdf

the only way to cope with the cyber theft scenario in the recovery phase would have been to provide an extremely low number for the 'highest daily value of the sum of all cash transferred' (even though the period for determining this number includes the Covid-19 outbreak) or an enormously high equity to cover the losses.

Further, the 'scenarios did not take into account ways in which the CCP's operational arrangements or cyber security measures might reduce the risk or extent of loss.' In particular, cyber security threats would be prevented and addressed through the application of dedicated cyber threat measures that are embedded in CCP's operational resilience and cybersecurity policies. Please note in this context that the improvement of operational resilience and cyber security is currently high on the regulatory agenda of EU policy makers, with several initiatives currently in the making that aim to make the existing EU framework even more resilient and secure.

As mentioned above, the results of the scenario should therefore be interpreted cautiously, as they could have been different would CCPs have interpreted the given scenario differently and would have applied operational arrangements and/or cyber security measures.

C) Conclusions

To conclude, CCPs have carefully designed their risk management procedures, financial resources and recovery and resolution tools to manage market stress and ensure appropriate incentives for market participants to effectively manage their risks. In line with the PFMI's international standards and Article 16 of the EMIR legislation as well as the new EU CCPRRR regime, CCPs in the EU hold efficient tools and sufficient resources proportionate to the risk stemming from the activities of the CCP to address NDLs. As pointed out above, it is also important to recognise that CCPs' resources for recovery and resolution cannot be considered in isolation from other CCP risk management tools. As recently demonstrated by the unprecedented market stress during early 2020 and the recent turmoil during and since the Ukraine invasion, CCPs are well prepared for managing extreme stress events.

Finally, Eurex Clearing appreciates the FSB's analysis and more generally, the aim of international standard setting bodies to further support the stability of the broader financial system. However, Eurex Clearing believes that the recent report confirmed the resilience and sufficiency of the current risk framework for CCPs in managing extreme market stress. While Eurex Clearing would appreciate the clarification of some elements of the FSB's analysis, in particular in relation to the implications of using VMGH as mentioned above, Eurex Clearing would like to emphasise that Eurex Clearing does not consider further policy work on the sufficiency of the recovery and resolution tools, including potential alternative resources and tools, in particular on the NDL side, necessary. Rather, Eurex Clearing would welcome if the FSB's and other standard setting bodies' upcoming policy work continue to focus on the different jurisdictional progress made in building and implementing CCP recovery and resolution frameworks in line with the existing global standards.