

WFE response to the Financial Stability Board's discussion paper on the financial resources to support CCP resolution and the treatment of CCP equity in resolution

February 2019

We are grateful for the opportunity to respond to the Financial Stability Board's (FSB) discussion paper on financial resources to support CCP resolution and the treatment of CCP equity in resolution.

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 200 market-infrastructure offerings, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~21%). This includes over 50 distinct CCP clearing services, with everything from local entities in emerging markets to stand-alone CCPs based in major financial centres.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise financial stability, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

The WFE welcomes this discussion paper and the associated work of the FSB and global standard setting bodies to develop frameworks for the sound regulation of derivatives markets and the supporting market infrastructure. Whilst the scenarios in which a CCP would need to be resolved are extreme and remote, the work done by authorities in preparation gives a degree of clarity to stakeholders concerned with managing their risk. It is helpful in exploring and clarifying how authorities should work with the market, with market infrastructures in particular and with their international counterparts to achieve the best possible outcome for the financial system.

We support how the FSB has articulated the role of a CCP vis-à-vis its clearing members and emphasized the importance of developing an incentive structure that supports the stability of the broader financial system and the continuity of a CCP critical services. Furthermore, this paper rightly suggests that an important factor in assessing a CCP's financial resources for resolution is a consideration of the products a CCP clears and the specifics of the regulatory framework under which it operates.

We believe the interests of the financial system are best served by a regime that is designed primarily to avoid resolution and instead, incentivize market participants' active participation in the recovery process. In the extreme and remote scenario of a potential CCP resolution, the resolution authority should intervene after the exhaustion of the resources and tools defined for recovery in a CCP's rulebook and recovery plan. If a resolution authority were to intervene prior to this, the incentives market participants have to actively participate in the recovery process are undermined.

We encourage the FSB to keep its focus on assessing the financial resources available for CCP resolution and the treatment of CCP equity in resolution, rather than be diverted into 're-litigating' existing recovery tools. In particular, we note with concern the prospect of compensation procedures in the discussion paper. This risks introducing new moral hazard in the recovery process and *increases* the likelihood that public intervention would be required.

The *Key Attributes of Effective Resolution Regimes for Financial Institutions* (including the Further Guidance thereof) and *Principles for Financial Market Infrastructures* (PFMI) remain the core guiding documents for avoiding and addressing the resolution of a CCP. They explicitly address how CCPs must take into account the wider interest. As the PFMI states:

*"An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders."*¹

¹ CPMI, [Principles for financial market infrastructures](#), April 2012.

To demonstrate a CCP's confidence in its own risk management practices, authorities have introduced the concept of skin-in-the-game. As the discussion paper notes:

"SITG is not calibrated with a view to constituting a significant amount of loss absorbing resource. Rather, SITG is calibrated to provide confidence in the risk-management incentives of the CCP."²

This statement is welcome and highly relevant in the consideration of resolution regimes. Crucially, a CCP should not serve as a guarantor for the risk taking of its participants. It exists to manage the systemic risks intrinsic in trading, especially of derivatives, by requiring that those who create risk exposures back them up with sufficient resources. It would be inappropriate for a CCP to underwrite – or even be seen to underwrite – risks taken by clearing members. Suggesting that a CCP should serve as a guarantor for the financial system undermines cleared derivatives market structure and the incentives for its participants to appropriately manage the risks they bring to the cleared derivatives ecosystem.

Following on from this, any undue emphasis on the mechanisms for compensating clearing members in a CCP resolution scenario risks perverting the incentives that exist to support the default management process and recovery of that CCP. As the discussion paper acknowledges:

"Relevant authorities and CMGs [Crisis Management Groups] will need to consider how local insolvency law, resolution powers of relevant authorities, and a CCP's rulebook interact and ensure that their approach does not have an adverse impact on the incentives for stakeholders, particularly clearing members, to support recovery and attempt to avoid resolution."³

The resolution of a CCP would be a highly disruptive extreme tail event; the recovery of a CCP is a far preferable outcome for all concerned. The resilience practices and recovery plans that CCPs have adopted in the post-crisis era have been carefully designed in close co-ordination with a CCP's local regulatory authorities in consideration of applicable international standards.

Any plan developed by resolution authorities should be mindful of the potential impacts on a CCP's risk management and recovery tools and be designed to ensure that it does not reduce the likelihood of successful CCP led recovery. The operation of such a plan should be a joint effort between the CCP and its home regulator, with appropriate communication with other global regulators through the Crisis Management Group. A regime providing incentives for clearing members to see the CCP resolved rather than recover would be antithetical to supporting the stability of the broader financial system and inconsistent with the *Principles for Financial Market Infrastructures*.

The circumstances that might give rise to the enactment of a CCP recovery plan are extreme. It is important that the CCP can discharge the policies set out in its rulebook in such a stressed scenario. Likewise, it is important that it retains sufficient flexibility to discharge its recovery plan in a manner that takes account of the particularities of the situation, the specificities of its own corporate/legal structure and that ultimately supports the stability of the broader financial system.

Ownership structures diverge significantly across CCPs and other critical infrastructures may exist within the wider group. Where the CCP is part of a larger group, resolution authorities should duly consider the impact of the resolution of the CCP may have on other legal entities within the group and treat the CCP as a fully separate entity to avoid contagion in a crisis scenario. Therefore, we recommend that guidelines propose to assess the resolvability of the CCP on a standalone basis; prescriptive approaches regarding parent entity support would be inappropriate.

Please note: in what follows, we have elected to focus on those questions (1, 3, 11, 13 and 14) that are of most relevance to us. Naturally, we would be willing to comment in more detail and on other questions, as relevant.

² FSB, [Financial resources to support CCP resolution and the treatment of CCP equity in resolution](#), November 2018.

³ Ibid.

Question 1: Do you agree with the suggested five-step process to evaluate the financial resources and tools for resolution? What other elements, if any, should be considered?

While the WFE agrees with much contained in the five-step process proposed, we are concerned that elements might invite re-litigation of CCPs' existing recovery tools through an overly broad scope. We believe the process should assume:

- (i) the continued existence of CCPs' current recovery tools;
- (ii) the continued existence of CCPs' current ownership structures until resolution (i.e. excluding changes to equity positions that could result from resolution); and
- (iii) the legal enforceability of the recovery tools assumed in (i) and the ownership structures assumed in (ii).

If the process makes the assumptions above, it would enable stakeholders to more narrowly focus on assessments of the financial resources available to a CCP in resolution and the treatment of a CCP's equity in resolution, as we believe the FSB intends.

While the paper necessarily addresses issues related to resolution, it must be reiterated that such a scenario would represent a suboptimal outcome, even in the context of severe stress. Resolution plans should be dovetailed to the operation of resilience mechanisms and recovery planning; they should only be embarked upon once all the mechanisms of resilience and recovery have been exhausted, and resolution is determined to clearly support the stability of the broader financial system. Authorities should assume the functioning of a recovery plan and as a matter of principle not enter into resolution before CCP's recovery tools have been employed.

Nevertheless, we acknowledge that the resolution authority may have a degree of discretion concerning the timing of entry into resolution, and may choose to take this measure earlier rather than later when it is clearly in the interests of financial stability. The prospect of an early entry into resolution could have negative impacts on the incentives of market participants to actively participate in the default management and recovery processes. Undermining these incentives could in turn increase the likelihood of resolution—an outcome that benefits no one and which is likely to undermine the stability of the broader financial system, an objective that CCPs are designed to support.

WFE also appreciates the five-step processes' recognition of the importance of an application that considers the specific characteristics of the CCP being assessed (e.g., products cleared and risk management practices) and the regulatory framework under which CCP operates. We believe considering these specific features is critical to yielding a useful assessment.

Question 3: Should the assessment of financial resources for CCP resolution take into account (a) different CCP ownership structures; (b) different CCP organisational structures; or (c) the products cleared by the CCP? If so, how?

We agree that these three characteristics should be taken into account in the assessment of financial resources for CCP resolution. CCPs operate under different ownership and organisational structures and clear different products and these differences will inform how a CCP's potential resolution would function. These such differences should be factored into any assessment that is conducted.

For example, if resolution authorities wish to consider whether a CCP's current shareholder(s) are willing to make further voluntary financial contributions to the CCP in recovery, the ownership structure of the CCP must be taken into consideration. The ownership structure may also have an impact on the incentives of clearing members and other stakeholders at various stages in the resilience, recovery and resolution scenarios. Aligning the incentives of clearing members with the public interest is crucially important.

Where the CCP is part of a larger group, resolution authorities should duly consider the impact the resolution of the CCP may have on other legal entities within the group and treat the CCP as a fully separate entity to avoid contagion in a crisis scenario. Therefore, we recommend that guidelines propose to assess the resolvability of the CCP on a standalone basis; prescriptive approaches regarding parent entity support would be inappropriate.

Furthermore, it is of the utmost importance that the specifics of a CCP's rulebook and recovery plan, as well as the regulatory framework under which it operates, are considered in the assessment.

Question 9: Do you agree that the key issues to CCP equity bearing loss in resolution have been accurately identified? Are there other key issues regarding equity bearing loss? What are they and how should they be addressed?

The WFE welcomes the FSB's characterization of skin-in-the-game equity. Crucially, a CCP is not should and not serve as a guarantor for the risk taking of its participants. It exists to manage the systemic risks intrinsic in trading, especially of derivatives, by requiring that those who create risk exposures to back them up with sufficient resources. It would be inappropriate for a CCP to underwrite – or even be seen to underwrite – the risks taken by clearing members. Suggesting that a CCP should serve as a guarantor for the financial system undermines cleared derivatives market structure and the incentives for its participants to appropriately manage the risks they bring to the cleared derivatives ecosystem.

Any arrangements for allocating losses to equity prior to resolution, other than by voluntary skin-in-the-game arrangements, should be negotiated and agreed between clearing members and their CCPs in advance. Public authorities should not create an expectation that previously agreed loss allocation arrangements would be altered by resolution authorities. Proposals contained in the discussion paper to compensate clearing members with CCP equity would create perverse incentives and likely undermine financial stability objectives.

We recognize that CCP equity should be a consideration in resolution planning. One key factor to consider with respect to its use is that the tools and resources defined for recovery under a CCP's rulebook and recovery plan must have been exhausted; it is critically important that no equity write downs be permitted until members have met all their obligations under the CCP's rules. Furthermore, in contemplating any equity write-down during resolution, consideration must also be given to such a measure's impact on other CCP products and potential procyclical effects.

Question 11: What are your views on the possible mechanisms for adjusting the exposure of CCP equity in bearing loss in resolution set out in Section A? What other possible mechanisms, if any, should be explored?

The discussion paper recognizes that there are a number of means for potentially adjusting the treatment of CCP equity in resolution for CCPs with certain ownership structures. However, none of these measures should be taken until the CCP has been able to exhaust the tools and resources it has defined for managing a stress event in its rulebook and recovery plan.

We believe transferring equity stakes in the CCP to clearing members and clients in return for losses incurred during resolution is an inappropriate approach for a resolution authority to take because of negative impacts it has on market participants to actively participate in the recovery process. It would pervert clearing members' incentives to bid appropriately in the auction process, in the knowledge that additional loss allocation tools beyond the default fund would be reimbursed at a later stage. Furthermore, such an approach may create incentives for clearing members to argue for a lower overall level of mutualized, pre-funded resources.

Equity compensation and concomitant change in role of clearing members and clients would fundamentally alter market participant incentives, thereby threatening the independence and risk management prerogatives of the CCP. It would undermine both the likelihood of a successful recovery as well as the prospect of the successful sale of the CCP in resolution. While we believe that equity ownership would most egregiously pervert incentives for market participants, other forms of compensation may create similar disincentives for market participants to participate in the recovery process. They should be closely evaluated from that perspective by policymakers.

Should resolution authorities consider incentivizing clearing members to participate financially in a CCP's recovery or resolution (beyond their existing obligations), the WFE supports the principle in the discussion paper that compensation should be forthcoming to the extent clearing members contribute *in excess* of their obligations under the CCP's rulebook. In this way, compensation would be exchanged for 'new' money. In line with relevant contractual undertakings, this should only occur after existing shareholders have had the opportunity to exercise applicable pre-emption rights. We accept that authorities may consider compensation to clearing members when the resolution authority's actions abrogate rights under the NCWOL framework.

In this discussion, it is worth recalling the fact that additional resources in recovery and resolution are deployed to ensure that the contracts of clearing members continue being honored; they do not accrue to the CCP.

Question 13: What are your views on the potential constraints and challenges described in Section C? Are there other challenges or constraints to equity bearing loss? What are they and how should they be addressed?

The FSB highlights the possibility of enforceable claims by shareholders to preserve the objectives of the NCWOL framework. We believe that in determining these claims the counterfactual to the CCP's bankruptcy should be the complete application of the CCP's default management procedures and recovery plans (including a holistic consideration of the ancillary costs arising from such action). As such, the point in time for imposing losses on CCP equity (beyond skin-in-the-game) should be, at the earliest, at the end of the application of all recovery tools defined in a CCP's rulebook.

We reiterate our concern that depleting equity may increase the risk of internal contagion within the CCP and undermine financial stability. Furthermore, writing down CCP equity before the end of the recovery plan could have significant consequences for the structure of the CCP post-resolution.

Question 14: Section D outlines a number of policy considerations for the treatment of CCP equity in resolution. Are they appropriate and comprehensive? Would you suggest any additional policy considerations?

We welcome the FSB's acknowledgement of the appropriateness of authorities considering clearing member incentives to support recovery and avoid resolution. We agree that authorities should consider the impact on clients of clearing members of a CCP's resolution; alongside clients, it is important to account for the impact on the end-users of financial services. In most cases, the continuity of a CCP's critical services is a key tenet in supporting the stability of broader financial system due to the reliance of these clients on the risk management tools offered by the CCP. Thus, the continuation of CCP services is often fundamentally intertwined with financial stability.

The FSB further outlines the importance of continuity of access to critical clearing infrastructure. Discontinuity of access to CCP clearing services could exacerbate risks to the financial system by denying market participants important risk management tools. The same applies to spill-over effects on other financial infrastructures from the resolution of a CCP, including infrastructures in the same corporate group as the CCP. For this reason, it is important that a group containing a CCP be permitted the opportunity to recapitalise the CCP in the recovery phase to the extent possible and within the confines of its rulebook and undertakings to authorities.