Response: FSB Financial Resources & Tools for CCP Resolution

Background

Established in 1961, the World Federation of Exchanges (WFE) is the global industry association for exchanges and clearing houses (CCPs). Headquartered in London, it represents over 250 market infrastructure providers, including standalone CCPs that are not part of exchange groups. Of our members, 34% are in Asia-Pacific, 45% in EMEA, and 21% in the Americas.

The WFE's 90 member CCPs and clearing services collectively ensure that risk takers post some $1.3 trillion (equivalent) of resources to back their positions, in the form of initial margin and default fund requirements. WFE exchanges, together with other exchanges feeding into our database, are home to over 50,000 listed companies, and the market capitalisation of these entities is over $100 trillion; around $140 trillion (EOB) in trading annually passes through WFE members (at end 2022).

The WFE is the definitive source for exchange-traded statistics, and publishes over 350 market data indicators. Its free statistics database stretches back more than 40 years and provides information and insight into developments on global exchanges. The WFE works with standard-setters, policy makers, regulators, and government organisations around the world to support and promote the development of fair, transparent, stable and efficient markets. The WFE shares regulatory authorities' goals of ensuring the safety and soundness of the global financial system.

With extensive experience of developing and enforcing high standards of conduct, the WFE and its 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 the common good, 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 a globally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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Introduction

The WFE appreciates the opportunity to comment on the Financial Stability Board (FSB) Consultation report on Financial Resources and Tools for Central Counterparty Resolution (the Report), and to share perspectives and feedback on behalf of our members. The WFE and its members share the FSB's goals of ensuring the safety and soundness of the global financial system, which is critical to enhancing investor and consumer confidence. We therefore remain supportive of the broader effort to ensure that the international policy framework best promotes the resilience, recoverability, and resolvability of CCPs in default and non-default loss scenarios.

The WFE has previously publicly expressed support for initiatives that support financial stability led by international standard setters and local regulatory agencies, and has sought to proactively contribute to the discussion on these matters. In doing so, its members have contributed significantly to the strengthening of the broader financial system through engagement with regulators and other stakeholders on the implementation of many post-crisis initiatives.

Response

The WFE welcomes the work of the FSB and international standard setting bodies to evaluate frameworks for the sound regulation of global markets and the supporting market infrastructures. In regard to matters of resolution, we appreciate efforts to support continuity of clearing services and the stability of the broader financial system, but note that the scenarios in which a CCP would need to be resolved are extreme and remote.

Prior Reports on Resources for CCP Resolution

The WFE recognises the work undertaken by the FSB to date on the sufficiency of CCP resources. The international standard setting bodies, including the FSB, have already concluded in the 2022 report *Central Counterparty Financial Resources for Recovery and Resolution*[1] (the 2022 Report), that all of the participating CCPs "would have had sufficient prefunded and recovery resources and tools to cover losses in the applied default loss scenarios", and that no CCP had to enter resolution, despite the scenarios being "intended to be significantly more severe than the 'extreme but plausible' standard set out in the PFMI."

In particular, despite the implausible default loss scenarios set out in the 2022 Report, seven of the fifteen CCP service lines were able to fully address the extreme default losses with only their prefunded financial resources, and of the eight CCP service lines that used recovery tools, six were able to address the losses by utilising their recovery cash calls. Although the non-default loss scenarios analysed in the 2022 Report were extreme and implausible, the participating CCPs largely had sufficient resources and tools to navigate the scenarios. Furthermore, one scenario triggering resolution for some CCPs should not be the basis for further work given the extreme and implausible nature of that exercise.

Following the outcomes of the 2022 Report, the WFE believes that the new Report does not provide sufficient evidence to support the proposal for additional resolution-resources and tools. A policy-making approach which is not supported by any data and analysis is concerning, since there is no clear evidence on which to base any further proposal. While the new Report states that "[j]urisdictions should determine and make transparent their approach to calibrating one or more resolution-specific resources and tools in the resolution toolbox, for both default losses and non-default losses, which will serve as an expected amount of resolution-specific resources and tools that can be relied upon for resolution", the Report fails to demonstrate that resolution-specific resources and tools are necessary. We do, however, appreciate that FSB has prioritised flexibility in its approach, as flexibility is key in enabling CCPs and their relevant authorities to design the appropriate tools and strategies for the CCP and the markets served.

The Report correctly highlights that "no resource or tool, by itself, would be able to satisfy all aspects of the resolution resource parameters without some negative effect on financial stability or other drawbacks". Despite this, the Report proposes to amend the FMI Annex of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2014) to include a resolution

[1] Financial Stability Board, Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions, *Central Counterparty Financial Resources for Recovery and Resolution* (March 2022).

toolbox that “should include a combination of resolution-specific resources and tools that the resolution authority can apply… without a material adverse effect on financial stability.”

The list of resources and tools outlined in the Report include bail-in bonds, resolution cash calls, resolution funds, resolution-specific insurance, resolution-specific third-party contractual support, statutory or contractual variation margin gains haircutting (VMGH), and equity write-down. Each of the seven resolution-specific tools and resources included in the FSB’s proposed toolbox could have varying adverse effects on CCP resilience and recovery, and broader financial stability, some of which are outlined by the FSB in the Report.

Along these lines, the WFE is of the view that parameters C and D relating to financial stability and preserving incentives for clearing are collectively the most important to consider and, in particular, parameter D (preserving incentives for participation in recovery and central clearing) appears to be under-weighted versus the other three parameters (A, B and C).[2]. While a resource can provide loss absorption capacity, be available in a timely manner and operationally sound, it could ultimately undermine incentives for central clearing and financial stability by increasing costs and disincentives to participation to the detriment of the global marketplace. Hence, the WFE disagrees with the FSB statement that “after due consideration, the FSB determined that none of the parameters and their underlying analytical dimensions could be prioritised over others and instead all are essential in establishing an effective set of resolution resources and tools capable of addressing the various scenarios that could lead to resolution."

Due to the insufficiency of data demonstrating the need for resolution-specific resources and tools for CCP resolution, the WFE calls upon the FSB to support financial stability by continuing to prioritise, and encourage supervisory authorities to recognise the need to incentivise market participants to effectively manage their risks and ensure that their work appropriately recognises each CCP’s unique ownership structure, products, and markets they serve.

Unintended consequences on central clearing and financial stability

Requiring resolution-specific resources and tools could incentivise resolution over recovery, and in the case of user-owned CCPs, increase costs of clearing. For example, in CCPs that are public companies with shareholders that are not also user-owners , dedicating specific resources to resolution, particularly through equity write-down, creates a disincentive for clearing members to actively participate in the default management process and engage in the recovery process, since these specific resources will impact clearing members’ cost-benefit analysis. This outcome contradicts current international standards[3] consistent with which CCPs have carefully designed their financial resources, including default waterfalls, and recovery plans to promote a successful recovery, particularly through clearing members’ active participation in the default management process. More broadly, a CCP’s financial resources and recovery tools, such as cash calls, establish incentives for market participants to effectively manage their risks and these incentives must be preserved.

Some of the proposed resolution-specific resources and tools would also disincentivise the use of central clearing (e.g., by increasing costs) counter to the G20’s commitments following the financial crisis, and/or not make sense for use for some CCPs (such as user-owned CCPs). For example, the proposal for a resolution fund to be established or for CCPs to issue debt that they do not need to address extreme and implausible scenarios, including default and non-default losses, would impose significant costs that likely would have unintended negative effects on market participation. These increased (and uncertain) costs would likely be passed onto market participants and could undermine their ability to effectively manage their business risks, by preventing them from hedging and/or forcing more participants into riskier, non-centrally cleared bilateral markets where available.

CCPs are not banks

The WFE is concerned that the Report’s proposals attempt to impose the resolution framework for banks on CCPs. In this regard, the WFE is particularly troubled with the proposed inclusion of bail-in bonds and equity write-down as part of the proposed toolbox. CCPs should not be considered within the prism of resolution regulation designed specifically for banks, which can include the ability

[2] Parameter (A): Provide sufficient loss absorption, CCP recapitalization options, and liquidity, to give resolution authorities a reasonable opportunity to achieve a successful resolution in DL and NDL scenarios; Parameter (B) Be reliable and readily available in resolution and Parameter (C) Mitigate potential adverse effects on market stability.

[3] Committee on Payments and Market Infrastructures and Board of the International Organization of Securities Commissions, *Recovery of financial market infrastructures*, ¶ 3.3.8 (July 2017).

to recapitalise an entity using equity or convertible debt such as bail-in bonds. CCPs are markedly different from banks, particularly, since CCPs are not risk-takers, but risk managers, thus, the objective of a CCP's recovery is to provide for the continuity of its clearing services, including to re-establish its matched book and to restore its position as a market-risk neutral counterparty.

In a default loss scenario, in the event that a CCP's pre-funded resources cannot absorb the losses, then the CCP is able to use its additional rules-based recovery tools available as set forth in the CCP's default waterfall to resolve the remaining uncovered losses. This may include calling for additional resources from its clearing members to absorb losses, and if that is insufficient, then, in the case of derivatives clearing, the CCP may also haircut mark-to-market portfolio gains of market participants, while also conducting a tear up process. This is a robust, orderly, and pre-agreed sequence that occurs prior to a CCP needing to implement its orderly wind-down plan or enter resolution, that is designed to re-establish a matched book and fully address the losses associated with the defaults. CCPs are similarly positioned when it comes to addressing non-default losses, as affirmed by the FSB's 2022 Report. We also emphasise that in addition to the access to recovery tools by resolution authorities CCPs also have orderly wind-down plans, and we encourage resolution authorities to consider how those tools/resources could be re-purposed for use in resolution, just as much as their consideration of recovery tools.

As noted above, CCPs have demonstrated their ability to absorb severe market shocks under various historical distress situations (such as Long-Term Capital Management in 1998, Lehman Brothers in 2008, and MF Global in 2011). This was also affirmed by the 2022 Report, and the scenarios, including for non-default losses, designed to be significantly more severe than the 'extreme but plausible' standard set out in the PFMI[4]. Applying 'bail-in' bonds to CCPs could promote CCP resolution over recovery by disincentivising some clearing members from actively bidding in defaulted portfolio auctions or engaging in recovery efforts, and likely add additional uncertainty regarding both seniority[5] and the premium the bonds would require (given that holders would, in effect, be taking on the risks associated with a systemic meltdown). Of particular concern is that this tool would turn CCPs into more leveraged institutions like banks, leading potentially to increased risk of instability. Issuing bail-in bonds may also not be feasible for all CCPs based on their ownership structures and ability to issue long-term debt securities. It is also questionable as to who would seek to own such bonds, given that members would already be exposed to the CCP and unlikely to accept additional exposure, while selling the bonds to non-members/non-participants could create contagion risk. This tool is also redundant for user-owned CCPs, where bond holders would be member-owners or clients of such members.

Other drawbacks of proposed resources and tools

The WFE believes its beneficial to highlight additional drawbacks of specific resources and tools proposed. For example, in the case of insurance, there is uncertainty over factors such as timing of payouts and actual coverage that would be provided to under specific facts and circumstances surrounding the resolution. Insurance may also constitute a potentially significant expense for an extremely unlikely event of a CCP entering into resolution. The Report also fails to highlight the cross-border implications of regional resolution funds. Negative consequences could arise from scenarios wherein multi-CCP funds are called upon by many CCPs simultaneously in the event of a broad crisis (the Report does not recognise that the most likely of unlikely events to cause CCP resolution is a systemic one, so resources may be needed for multiple CCPs at once). Furthermore, A resolution fund for CCPs does not make sense in the same way it does for banks, which fail much more often, based on the inherent riskiness of their business model.

Regarding resolution cash calls and VMGH, these measures are already in place for many CCPs. However, these measures can have drawbacks as well, and CCPs should still have flexibility in determining their use. Mandating additional resolution-specific cash calls risks further increasing the cost of clearing. VMGH is also an imprecise way to allocate costs given the potential for members and end-users to hedge across multiple CCPs, which makes their "winning" position at the CCP performing VMGH misleading, thereby exacerbating financial and liquidity strains.

[4] International Organization of Securities Commissions (IOSCO), 'Principles for Financial Market Infrastructures (PFMI)', p 1, April 2012, https://www.bis.org/publ/cpss101a.pdf

[5] Issues regarding debt instrument seniority were seen during the write-down of additional tier-one (AT1) bonds by Swiss regulator FINMA as part of the Credit Suisse takeover by UBS in 2023. Standard resolution authority hierarchy requires equity investments to be written down first and classed as secondary to bonds. The European Central Bank and European Banking Authority outlined this divergence, stating that in the European Union, 'common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier 1 be required to be written down.'
Single Resolution Board, ' EU regulators distance themselves from Credit Suisse bond writedowns', 30 March 2023, https://www.srb.europa.eu/en/content/eu-regulators-distance-themselves-credit-suisse-bond-writedowns

Ownership models, jurisdictional considerations, and required flexibility

When considering the impacts of the Report's proposal, it is also important to consider the full range of CCP ownership models, how supervisory and resolution authorities operate depending upon the jurisdictions, and how CCP's unique loss-allocation processes serve to align the interests of members and the CCP. It is crucially important to consider the varied regulatory environments in which CCPs reside, such as those where the supervisory authority and the resolution authority are not the same. First and foremost, the possible choices of tools should be left to a given CCP pursuant to its local regulatory requirements and we would encourage coordination between supervisory and resolution authorities in jurisdictions where they are different authorities. As outlined in our 2017 position paper[6], CCPs must maintain appropriate flexibility to design their recovery tools in a manner that is appropriate for their unique offerings. Without this flexibility, local regulatory regimes may become too prescriptive and inappropriate by imposing requirements that are not tailored to the characteristics of the specific CCP, undermining the potential likelihood of successful default management and recovery processes.

Conclusion

The WFE agrees that effective resolution regimes for systemically important CCPs remain critical for supporting financial stability and ensuring confidence in the financial system. However, policy-makers must take into account the fact that CCPs have continued to successfully manage the risks brought by their market participants, despite multiple periods of market shocks and volatility. While we appreciate the work of the FSB to support the stability of the broader financial system, the WFE does not agree with the conclusion in the Report that further CCP financial resources and tools for resolution is needed. We believe that the previous consultation results and the ongoing robustness in centrally cleared markets demonstrates the sufficiency of the existing resource structure, combined with the sound risk management practices employed at CCPs. We do appreciate, however, the FSB's prioritisation of flexibility in their approach so that CCPs can tailor tools and resources based upon ownership models and markets served.

Furthermore, we question the suggestions by the FSB that specific resources for resolution are needed and that CCPs are not best-placed to determine a CCP's resource mix, and warn against any guidance or standards that could encourage a supervisor or resolution authority to mandate the implementation of certain resources which may not be suitable for a given CCP. As highlighted by the Report, "use of these resources and tools might be destabilising or inappropriate in certain circumstances". It is the WFE's view that CCPs are best placed to maintain the delicate balance of incentives amongst market participants and that international standard setters should not encourage the use of additional tools, even via a toolbox approach, in order to preserve the flexibility required by CCPs to serve specific markets, in different legal jurisdictions, and in consideration of their different structures.

Any standards should be designed to ensure that they do not reduce participation in cleared markets or the likelihood of successful CCP-led default management process and recovery. Guidance that provides incentives for market participants to see the CCP resolved rather than recover would be antithetical to supporting the stability of the broader financial system and inconsistent with the PFMI.

[6] World Federation of Exchanges, 'The Interplay between Central Counterparty (CCP) Recovery and Resolution: A Global Perspective White Paper', https://www.world-exchanges.org/our-work/articles/wfe-ccp-recovery-and-resolution-white-paper