

March 2017

# Financial Stability Board Consultative Document: Guidance on Central Counterparty Resolution and Resolution Planning



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# Background

The World Federation of Exchanges (WFE) is the global trade association for exchanges and clearing houses, representing more than 200 Market Infrastructure Providers, of which more than 100 are Central Counterparties (CCPs) and Central Securities Depositories (CSDs). Our members include exchange groups and standalone CCPs.<sup>1</sup>

Our members are both local and global, operating the full continuum of Financial Market Infrastructure in both developed and emerging markets. Of our members, 41 percent are in the Asia-Pacific region, 40 percent in EMEA and 19 percent in the Americas. WFE exchanges are home to nearly 45,000 listed companies, and the market capitalisation of these entities is over \$67.9 trillion; furthermore, around \$84.18 trillion in trading annually passes through the infrastructures our members safeguard.<sup>2</sup>

The WFE works with standard setters, policy makers, regulators and government organizations 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, which is critical to enhancing investor and consumer confidence, and promoting economic growth.

# Introduction

The WFE has previously publicly expressed support for initiatives such as the CPMI-IOSCO Principles for Financial Market Infrastructure (PFMI) and the FSB Key Attributes, and has sought to proactively contribute to the international debate on CCP risk management, recovery and resolution.<sup>3</sup> In doing so, its members have contributed significantly to the strengthening of the system via the implementation of many post-crisis initiatives, including efforts to encourage central clearing of derivatives as per the G-20 direction.

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, and promoting economic growth. In that context, WFE appreciates the opportunity to respond to this Consultative Document relating to CCP Resolution and Resolution Planning.<sup>4</sup>

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<sup>1</sup> The WFE membership list [can be found here](#)

<sup>2</sup> As at end 2016

<sup>3</sup> - [WFE: CCP Risk Management, Recovery and Resolution – Aligning CCP & Member Incentives – October 2015](#)

- [WFE: Response to CPMI-IOSCO Consultative Report on Resilience and Recovery of CCPs – October 2016](#)

- [WFE: Response to FSB Discussion Note on Essential Aspects of CCP Resolution – October 2016](#)

- [WFE: The Interplay Between Central Counterparty Recovery and Resolution: A Global Perspective – February 2017](#)

<sup>4</sup> [FSB Consultative Document: Guidance on Central Counterparty Resolution and Resolution Planning](#)

# Executive Summary

The following broad views are reflected in WFE's response to the Consultative Document:

- In the event of disruption, recovery should be given every opportunity to succeed before invoking resolution proceedings. Resolution Authorities should only step in when all CCP recovery actions have been exhausted, or in the interests of broader financial stability and the safety and security of financial markets.
- Whilst we agree with the principle of Resolution Authorities having explicit and appropriate powers to carry out the resolution of a CCP, the specifics of the situation need to be taken into account, and the effects of utilising those powers considered, on a case-by-case basis.
- On entering resolution, it is vital to strike the right balance between providing sufficient certainty to participants (including the CCP) and leaving the authorities with sufficient flexibility – bearing in mind the significant risks created by early entry in the CCP's recovery process – to make the correct decision to protect market stability.
- In particular, we caution on the risks of actions or steps that could skew the existing incentives for participants – incentives that are crucial to the orderly functioning of cleared markets. For example, transparency obligations need to be balanced to ensure they do not create incentives for market participants to behave in a manner that is self-serving and not for the benefit of the broader market.
- Further, we caution on the potential consequences of imposing additional financial resource obligations on CCPs and/or the wider clearing ecosystem – for example reducing the focus/distorting incentives on the risk management process, and the effect on end-users. It is crucial to balance the potential for increased security with the need to ensure appropriate incentives for clearing members.
- Finally, the WFE is a strong proponent of co-operation between relevant authorities, not only in the event of resolution, but also in the lead up to resolution. Crisis Management Groups, strong co-operation and information sharing arrangements are key, as is the participation in “simulated exercises” to ensure awareness of available powers, how they would work in practice, when they would need to be used, and the resulting impact on market operators and participants.

Below we frame our detailed comments in line with the specific sections as set out in the Consultative Document:

## Specific Comments

### **1. OBJECTIVES OF CCP RESOLUTION AND RESOLUTION PLANNING**

The WFE agrees with the overarching FSB objectives of CCP resolution – namely that it is essential to restore the ability of the CCP to continue to perform its critical functions as a going concern, and/or ensure the ongoing performance of those functions by another entity or arrangement.

We also agree the priority of the Resolution Authority should be to maintain market and public confidence, whilst minimising contagion/disruption, in the pursuit of financial stability. This should include ensuring continued access for participants to CCP services, so long as that does not in turn lead to further CCP disruption, or wider financial stability concerns.

However, we respectfully note that CCP resolution is a worst-case scenario in which CCPs are unlikely to find themselves given the strength of the resilience and recovery measures they implement.

**We consider, in the event of a disruption, CCP-led recovery should be given every chance to succeed before invoking resolution proceedings. This is in the interests of the market as a whole, particularly given the potential impact on the clearing ecosystem. Our view is that – whilst as noted below they should have a full range of appropriate powers and tools – Resolution Authorities should only step in when all CCP recovery actions have been exhausted.**

## **2. RESOLUTION AUTHORITY AND RESOLUTION POWERS**

### **Tools and Powers: General**

The WFE agrees with the overarching principle that the Resolution Authority should have relevant and appropriate powers necessary to carry out the resolution of a CCP. There is no benefit in restricting these tools or powers. Notwithstanding the existence of these tools and powers, we nevertheless reiterate our view that the Resolution Authority should only intervene when all CCP processes have been exhausted, or in the interests of ensuring financial stability.

The CCP is best placed to manage its own recovery and so generally loss allocation tools should only be used by CCPs; in all conceivable extreme but plausible scenarios, they are the most likely to manage an orderly recovery process. The tools and powers available to the CCP for recovery are expected to be sufficient to resolve the market stress, as they are typically developed using internationally agreed principles.<sup>5</sup> These tools and powers are defined and executed under detailed market oversight, having been published in the CCP's publicly available rulebooks, subjected to regulatory review, and designed to maximise financial stability by returning to a matched book, thus limiting overall market losses. However, Resolution Authorities should – throughout the recovery process – have sight of the process to ensure there are no measures undertaken by the CCP which have a negative impact upon financial stability.

In the event Resolution Authorities do need to intervene, it is vital to ensure they have the flexibility to consider the specifics of the situation, event, market and regulatory/legal environment in deciding how to manage the resolution process. Further, in an extreme case where a CCP-led recovery is suspended by the authorities, Resolution Authorities should in the first instance continue to follow the powers provided to the CCP as set out in its rules/processes in order to retain clarity and certainty to the market and its participants. However, the Resolution Authorities must also retain the flexibility to respond to the exact circumstances of the event and prevent gaming by market participants. If a Resolution Authority does intervene and decides to manage the CCP's loss-allocation due to financial stability concerns, it should be transparent to the market the precise systemic stability benefits of its stepping in, and the reasons for deviating from the CCP's plan.

**As such, whilst we agree with the principle of Resolution Authorities having explicit and appropriate powers to carry out the resolution of a CCP, we caution on the need to take into account the specifics of the situation, and consider the effects of utilising those powers, on a case-by-case basis.**

### **Default Losses**

Where available, in the event of a default leading to position auctions, we consider it may be appropriate to consider broadening the pool of potential bidders to include clients with appropriate capabilities and interest in bidding on the defaulter's portfolio. This should however be limited to clients with an active position in the asset on auction, and who have the infrastructure and financial wherewithal to support reasonable bidding. Previous experience suggests this would encourage active and successful bids, hastening a return to the matched book and market stability (while also protecting against unpredictable losses). In particular, we suggest, if the CCP has reached a point of considering more disruptive recovery tools (such as variation margin gains haircutting), clients of clearing members may be exposed to losses as a result of the unmatched book anyway. In this situation, as their funds and positions are put at risk, they have a tangible "skin in the game" and would thus be incentivised to actively bid in the defaulted portfolio.

In terms of other specific tools to help manage default losses, we believe that strategic partial tear-ups – after multiple auction rounds where the CCP and participants can identify the markets which may no longer be necessary – are a crucial tool to restore a matched book. Where a small subset of toxic or obsolete products have proven to be insufficiently liquid through multiple failed auctions, it should be possible to tear up these contracts to avoid more significant losses to the broader market. However, to the extent there are clear systemic risks because of tear-ups made by the CCP, the Resolution Authority should step in (in its wider financial stability capacity). Variation gains haircutting, as an extreme loss allocation tool, can effectively focus losses on those market participants who are in a position to absorb losses in an unprecedented market event and so can be useful.

<sup>5</sup> [CPMI-IOSCO's report on the Recovery of Financial Market Infrastructures](#)

## Non-Default Losses

Regarding non-default losses, we agree that Resolution Authorities should have relevant and appropriate powers.

However, there are different types of non-default losses that could impact a CCP. The allocation of losses during a non-default event should therefore be based on the type of event, the source of the losses, the role of the CCP and clearing member in determining the risk and the CCP's policies in managing these risks.

Specifically, there are non-default losses that are led by clearing members. Some CCPs allow clearing members to dictate where their money is invested after deposit at the CCP. In these circumstances, we would expect that clearing members are responsible for the losses, as they managed the decision as to where their money was held.

Other non-default losses are caused by up- or down-stream issues that may impact the liquidity of a cleared market. For example, the failure of a custodian or settlement bank, which would delay clearing members' access to funds. Here, it would not be appropriate for the CCP to be wholly responsible for the liquidity squeeze or any potential losses caused by such an event. In many cases, clearing members choose their own custodian and/or settlement firms; such firms may also contract to sub-custodians, for whom they do not accept responsibility. Here, it would be inappropriate - where the clearing members have control over such decisions and the original firm can abscond from its liability through sub-custodians - that the CCP should retain full responsibility for losses associated with related stress events.

Furthermore, there are some circumstances, such as a severe operational failure on behalf of the CCP or where the CCP independently invests financial resources, where we would not expect losses to be allocated to clearing members, as the management of those risks was solely the responsibility of the CCP. In these cases, CCPs are responsible for protecting against such losses, with protections publicly reported in rulebooks and other disclosures, and absorbing any losses that exceed these protections.

Ultimately, there is not a uniform solution for every non-default loss possibility. Each situation needs to be considered and a decision based on individual merits.

## Equity in Return for Contributions to the CCP Resolution

We are concerned with, and caution on, the risks of awarding equity (or other instruments of ownership) in return for contributions to a CCP resolution. **Equity can be a highly inappropriate tool to compensate clearing members in the event of CCP resolution, especially if it results in a clearing member having inappropriate control of a CCP.** This can distort the dynamics of the CCP's functioning to the detriment of other participants by tipping the balance of powers that currently exist in a CCP between the membership (via the risk committee), the management of the CCP, the owners and the Board.

We are also concerned **this could skew incentives during recovery**, giving members motivation to allow recovery to fail if they are able to benefit from equity upon resolution. This is a particular risk if the member has already suffered losses during recovery, as is likely to be the case under these remote circumstances.

## **3. ENTRY INTO RESOLUTION**

The WFE supports the presumption that a Resolution Authority should allow CCP processes to proceed in an effective and timely manner. As noted in the February 2017 WFE white paper<sup>6</sup>, our view is that the decision regarding when to invoke resolution should only be taken if it is clearly necessary to provide for continuity of clearing services and market stability. We expect this would occur only once all recovery measures in the CCP's recovery plan have been exhausted, or if the on-going execution of the recovery plan is obviously going to create systemic stress in the broader financial markets.

It is important that Resolution Authorities maintain the necessary level of flexibility to determine the exact trigger point based on the particulars of the scenario at the time, specifically when the CCP-led recovery has proven ineffective or recovery tools would present a material risk to financial stability. Establishing a precise trigger point or pre-defined quantitative threshold in advance of the event limits the ability of authorities to react appropriately to what will be a unique and unprecedented event. Given the diversity of CCPs, the variety of risk management techniques they use, and the uncommon nature of such an event, it is difficult to identify an exhaustive and

<sup>6</sup> [WFE: The Interplay Between Central Counterparty Recovery and Resolution: A Global Perspective - February 2017](#)

complete set of indicators. The factors for determining timing of entry into resolution will be dependent on the stress scenario that threatens the CCP, and resolution authorities must be able to take the current market environment into account when making their evaluation.

**We therefore consider it vital to strike the right balance between providing sufficient certainty to participants (including the CCP) and ensuring the authorities have enough flexibility – bearing in mind the significant risks which would be created by early entry – to make the correct decision to preserve and protect market stability.**

#### **Potential Indicators**

We generally support the proposed explanatory indicators if they are taken as non-exhaustive, potential indicators. **Nevertheless, we caution the risks of publicising steps or timings of entry into resolution.** This is because such information may provide adverse incentives for participants to precipitate resolution, or to not fully participate in recovery, if they are aware of the next steps which they perceive to be more commercially beneficial.

#### **Co-operation Between Relevant Authorities in the Lead Up to Resolution**

The WFE is a strong proponent of co-operation between relevant authorities, not only in the event of resolution, but importantly in the lead up to resolution. This includes the formation of “crisis management groups” comprised of relevant stakeholders to ensure sound, smooth and orderly markets through any resolution event, and ensuring appropriate information sharing mechanisms. This also includes the need to have strong and clear information sharing arrangements in place that are well practiced and understood by all.

**However, we consider it important that such co-operation is initiated well before a crisis occurs to ensure there is a common understanding of how the various bodies would work together when facing market crises. Section 9 below further elaborates upon this.**

#### **4. ALLOCATING LOSSES TO EQUITY HOLDERS IN RESOLUTION**

We have previously (and more generally) noted the view that losses should be allocated to those that bring the most risk and are in the best position to absorb the losses. We have also described – and would again reiterate – the risk of providing an equity reward for clearing participants in the event they suffer losses. This is because some may feel that such reward is more commercially beneficial than the recovery process itself, and as a result be incentivised to not participate fully and in the best interests of the wider market through the recovery process. We further note we support a flexible and discretionary approach regarding the allocation of losses – supporting our view that all presumptive steps and entry into resolution should not be made public.

Whilst it is appropriate for a CCP to have “skin-in-the-game”, we do not consider it appropriate for the CCP owner’s equity to be fully drawn down when the issue was caused by a clearing member default.

In the event of a non-default scenario which was wholly the fault of the CCP, such an equity write down could however be appropriate.

**Therefore, as a general point, we encourage authorities to consider the specific facts of a given scenario as well as the potential impact on incentives in determining how to allocate losses. It is difficult, and often counter-productive, to prescribe an approach beforehand.**

#### **5. NO CREDITOR WORSE OFF (NCWO) SAFEGUARD**

The NCWO safeguard is an important principle to market participants but needs to be carefully structured to give Resolution Authorities the necessary flexibility to operate appropriately.

We agree with the general principle that the assessment of the losses that would have been incurred, and of the recoveries that would have been made if the CCP or relevant clearing service had been liquidated or terminated, should assume the full application of the CCP’s rules and arrangements and any other contractual agreements. Any deviation as determined by the authorities should be made clear and transparent.

We also note the nuanced counterfactuals based on the type of loss (e.g. default or non-default).

## **6. FINANCIAL RESOURCES**

### **Level and Suitability of Financial Resources**

When working to define the appropriate amount of pre-funded resources contributed by the CCP, it is crucial to balance the potential for increased security with the need to ensure appropriate incentives for clearing members. Unduly large CCP contributions can act to subsidise the risk of, and create the wrong incentives for, market participants both on an ongoing basis and during a default event as they are less likely to be subject to loss. CCP contributions, as with the contributions of clearing members, should therefore be balanced and commensurate with the risk bought to the clearing system.

We also note the risk that the imposition of additional CCP pre-funded resources may reduce the focus on the default management process - which is at the core of the CCP's role in the financial system - as well as distort incentives for participants vis-à-vis risk management, reducing the incentive for clearing members to support a balanced risk profile.

Additionally, we urge general caution to further increasing financial resource allocation to the clearing ecosystem. It has been well reported that end-users are finding it increasingly difficult to locate clearing members willing to support their clearing activity due to general increases in capital costs<sup>7</sup>.

### **Provision and Recovery of Temporary Funding**

In terms of temporary funding, we agree with the notion of - when determining amounts to be recovered, and treatment of any excess - generally seeking to follow the processes as described in the CCP's rules and procedures, and ensuring appropriate transparency.

## **7. RESOLUTION PLANNING**

The WFE agrees with the general principle that the development of the Resolution Authority's resolution plan should start with the CCP's recovery plan given the close relationship between recovery and resolution.

Further, we generally support the proposed list of aspects that the resolution plan should include descriptions of if they are taken as non-exhaustive. However, we caution it is not possible to design a single resolution strategy to effectively manage all potential scenarios, as there will be significant nuances and specificities of each event to consider. The circumstances that could lead to a CCP recovery or resolution scenario are unprecedented and would far exceed what are considered extreme and plausible. Further, markets - and the firms operating within them - vary, as do national and regional laws and regulations. As such resolution plans need to reflect and accommodate the unpredictable and idiosyncratic nature of such an event.

In terms of disclosure, we note the suggestion that Resolution Authorities should consider the merits of publicly disclosing some elements of the Resolution Plan, bearing in mind the effects and the potential risks of doing so (i.e. disincentives to participate in CCP default management and recovery processes if resolution seems commercially preferable for clearing members). This is important flexibility to retain; providing too much public information runs the risk of dis-incentivising participants to behave properly and in the interests of the wider market through a stress event.

**In general we consider it is vital to strike the right balance between providing sufficient certainty to participants (including the CCP) and leaving the authorities with enough flexibility - bearing in mind the significant risks which would be created by being too prescriptive and/or transparent.**

<sup>7</sup> [WFE Response to BCBS Consultative Document: Revisions to the Basel III Leverage Ratio](#)

## **8. RESOLVABILITY ASSESSMENTS AND ADDRESSING IMPEDIMENTS TO RESOLVABILITY**

As described in section 2 above, the WFE agrees with the overarching principle that the Resolution Authority should have all relevant and appropriate powers necessary to carry out the resolution of a CCP – including around measures to improve resolvability of CCPs. However, we agree that consideration should be given to the likely effects of using such powers on the functioning of the CCP and the markets it serves.

## **9. CRISIS MANAGEMENT GROUPS**

### **General**

The WFE is a strong proponent of co-operation between relevant authorities, not only in the event of resolution, but importantly in the lead up to resolution. This includes the formation of “crisis management groups” (CMGs) comprised of relevant stakeholders to ensure sound, smooth and orderly markets through any resolution event, and ensuring appropriate information sharing mechanisms. This also includes the need to have arrangements in place that are well practiced and understood by all.

As we are mindful of the challenges of co-ordinating responses of multiple regulatory authorities, we therefore believe the responsibility for the CMG should principally be led by the resolution authority of the jurisdiction where the CCP is established. The home authority must be empowered to make decisions at the time and execute the CCP resolution. This ensures that the process is led by the entity with an in-depth understanding of the CCP, expertise in the markets which the CCP clears, and its legitimate interests/rights based on the local legal and/or regulatory framework.

Obviously, this leadership must be in close consultation with the CCP’s home supervisory and prudential regulators, ensuring that – collectively – the regulators with the best information about the CCP in question remain responsible and can act in an efficient and timely way.

### **Information Sharing**

To facilitate cross-border cooperation, we agree it is essential to develop appropriate information sharing and co-operation mechanisms – both within the CMG, and with non-CMG authorities – which provide clarity and allow authorities to fully understand the impacts of their actions.

As such, the WFE considers it important that authorities participate in practical engagement and “simulated exercises” to ensure awareness of available powers, how they would work, when they would need to be used, and the resulting impact on market participants and operators. This will ensure that stakeholder groups are practiced in how to properly communicate throughout the process, and identify whether the group of authorities that will be contributing to a resolution process is in fact too unwieldy, incorporates too many authorities, or makes decisions which are politically driven – all of which should be avoided. The risk of any-or-all of these occurring is it would inevitably lead to delayed decision-making in what is a fluid and dynamic situation which requires fast action.

## **10. CROSS-BORDER EFFECTIVENESS AND ENFORCEMENT OF RESOLUTION ACTIVITIES**

As noted in the response to section 9 above, the WFE is a strong supporter of co-operation between relevant authorities. This extends not only to ensuring organisational and information sharing arrangements are in place, but also using those structures to consider challenges to the effectiveness of resolutions that have cross-border implications, for example the effects on operational links between infrastructure providers and/or market participants in different jurisdictions.

As also noted above, we consider it essential that these arrangements are “tested” through practical engagement and simulated exercises to ensure those arrangements work in practice. Market stress events are typically fluid and dynamic situations, which require quick decision making and clarity as to who is responsible for certain actions. This is best achieved through a combination of documented arrangements and practical testing.



## CONCLUSION

The WFE and its members are committed to ensuring their trading and clearing environments are secure, stable and resilient.

We welcome international efforts to enhance and strengthen the financial system through regulatory reforms that will – amongst other things – increase market confidence whilst reducing systemic risk. Investor confidence in public markets is crucial for the industry and, as markets evolve – and as G-20 mandates continue to be implemented encouraging greater central clearing of financial markets – legislators and FMIs should continue to work together to ensure risks are appropriately mitigated without undue or unintended consequences.

Whilst we consider that recovery must be given every opportunity to be successful, it is important nonetheless to have clear resolution plans and expectations in the event the recovery plan has been exhausted. In particular we note:

- Resolution Authorities should only step in when all CCP recovery actions have been exhausted or in the interests of financial stability.
- Resolution Authorities should have access to appropriate powers and tools to carry out the resolution of a CCP if necessary for financial stability or once the CCP's recovery has been exhausted, although it is important to consider the specifics of each situation, and the effects of utilising those powers and tools.
- It is vital to strike the right balance between providing sufficient certainty to participants (including the CCP) and leaving the authorities with sufficient flexibility – bearing in mind the significant risks created by early entry – to make the correct decision to protect market stability.
- In particular, we caution on the risks of actions or compensation that provide perverse incentives for participants, and the potential consequences of imposing additional financial resource obligations on CCPs and/or the wider clearing ecosystem.
- Co-operation between relevant authorities – not only in the event of resolution, but also in the lead up to resolution – is key. Crisis Management Groups, strong cooperation and information sharing arrangements are necessary, as are practical exercises to test those arrangements.

Ultimately, we are working towards the shared objectives of achieving fair, robust and resilient markets in which investors can have confidence. In that regard, the WFE and its members are keen to continue working with national and international authorities to ensure this.



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