

Response: FSB consultation on treatment of CCP equity in resolution

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WFE response to FSB CP on treatment of CCP equity in resolution

Introduction

The World Federation of Exchanges (WFE)¹ is grateful to the FSB for this opportunity to comment on CCP resolution arrangements². Depending on how these arrangements are structured, they can either reinforce the positive externalities that CCPs generate or jeopardise them.

A core element of central clearing's value is the predictability of the arrangements to address pre-specified contingencies, together with the incentive structure reinforced by these arrangements' predictability. This value has been enhanced by the extensive policy strides the international community has made to build on CCPs' reliability through the 2008 crisis and to ensure coherence and consistency in the policy applied to financial systems worldwide, particularly through the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMI). Default management and recovery processes developed by CCPs have been designed and tested in accordance with these principles and calibrated for a range of scenarios (whether previously experienced or not).

In this context, CCP equity serves a well defined, targeted purpose, addressing the business risk associated with a risk-management service offering. At the same time, CCPs maintain prefunded resources (comprising the 'default waterfall') to address clearing member default events under extreme but plausible market conditions – typically covering the default of at least the two largest clearing members of a given CCP. As such, CCP equity together with the default waterfall form a meaningful part of the overall 'package' of predictability that allows central clearing to enhance systemic stability. By the same token, changing the treatment of CCP equity and/or the use of resources comprising the default waterfall will have the opposite effect. Upset the tried and tested balance of incentives, and CCP-user behaviours will:

- i) change for the worse; and/or
- ii) become less certain.

In either case there would be detriment and, in turn, an individual CCP could face unnecessary and unexpected complications in working through a period of stress for itself and the system. In particular, the current treatment of CCP equity has been carefully determined, consistent with international standards, to promote incentives for market participants to back the risks they bring to the CCP, as well as to support the stability of the broader financial system. An essential part of this consists of incentivising market participants' effective participation in the default management and recovery processes.

Viewing resolution measures in isolation will not in our view "minimise adverse effects on financial stability" (to cite the FSB's own words from the consultation). Rather, it is necessary to consider the possible interaction between a) resolution measures and b) the incentives for market participants that use a CCP in each possible 'phase' of a CCP's operations, whether 'business as usual (BaU)', operation of the

¹ WFE members run 57 CCPs, which collectively ensure that \$1 trillion of resources is posted up front by those who choose to run financial-market risk. These CCPs operate to international standards, whatever their ownership structure, asset focus or location. The WFE also represents some 200 authorised full-service exchanges, listing securities, derivatives and other assets.

² ['Guidance on Financial resources to support CCP resolution and the treatment of CCP equity in resolution'](#). FSB, May 4th, 2020

default waterfall, or recovery. Creating potential rewards in resolution (eg, exposing all CCP equity as a first-loss resource) could undermine the CCP's resilience or its ability to recover.

We appreciate the continuing focus on financial stability, which is why we believe it pertinent to correctly identify and recognise the core role of a CCP. These are already structured to "minimise adverse effects on financial stability", guaranteeing the financial performance of the contracts they clear by becoming a creditworthy counterparty to each buyer and seller, through transparent rules-based arrangements. This is underpinned by their arrangements for BaU (notably the requirements on users to post appropriate resources), the default waterfall and recovery measures. This does not mean that a CCP's local authorities should not plan for resolution. It does, however, mean that international guidance on the treatment of equity in resolution should allow due flexibility for local resolution authorities (RAs) to undertake planning in a manner appropriate for their legal frameworks and CCPs, while avoiding any complications that are not a) strictly justified and b) consistent with the broader systemic objective.

It is also necessary, in our view, to understand the true nature of the 'liquidation counterfactual', particularly the inevitable and serious knock-on effects of closing a clearing segment. These effects may be difficult to quantify but go well beyond the immediate, direct costs associated with the commercial value of the given clearing service or the individual risk positions of participants. To be able to determine whether any creditor party is 'worse off than in liquidation', it is relevant to consider factors likely to be present in liquidation, such as how volatile markets would be in the sudden absence of clearing.

A major difficulty in approaches to resolution planning is establishing what type of extreme scenario is relevant and which type goes *beyond* plausible. Unfortunately, the draft guidance appears to propose a set of scenarios for adjusting the treatment of CCP equity that are extreme and *im*-plausible, namely: i) the failure of highly regulated third-party banks and custodians; ii) a CCP not being able to use its recovery tools; and iii) CCP shareholders not supporting recovery. In relation to these extreme but implausible scenarios, we note the following:

- i) **Custodian and Settlement-Bank Failures:** The assumption that CCP equity should be adjusted to bear all, or even part, of losses from custodian and settlement-bank failure is inappropriate. Throughout the financial system, liability is disclaimed where entities use third-party custodial and banking services and the same is appropriate where a CCP uses such services. It is not a CCP's role to provide a guarantee to the financial industry against custodian and settlement bank losses and providing such a guarantee could undermine a CCP's role to provide stability to the financial system as a creditworthy intermediary.
- ii) **Use of Recovery Tools:** The assumption that CCP equity should be adjusted to bear losses, itself based on a presumption that a CCP cannot use its recovery tools, is inappropriate. Consistent with local laws implementing the PFMI, CCPs are required to operate, which includes the use of its recovery tools, under a well-founded and enforceable legal framework. Consequently, the assumption that a CCP cannot use its recovery tools effectively implies that a CCP's legal framework is unenforceable.
- iii) **Shareholders' Support:** The assumption that CCP equity should be adjusted to bear losses, based on the presumption that a CCP's shareholders would not support recovery actions, is contrary to the fundamental incentives for shareholders to preserve franchise value, which is predicated on the continuity of the risk management offering.

It is important to recognise the negative impacts that adjusting CCP equity on the basis of extreme but implausible scenarios can have on incentives for market participants to participate in the default management and recovery processes. Inappropriately making additional equity available on the basis of these scenarios could undermine these incentives.³

Existing standards and legal powers already recognise the need for local authorities to undertake resolution planning, including defining scenarios, but do not endeavour to define granular scenarios for local authorities' planning. The FSB's current standards for resolution, as well as resiliency and recovery, recognize that local authorities must have the power to implement a framework that is appropriate for the unique characteristics of their CCPs and jurisdiction, in order to effectively support financial stability. Local frameworks for resolution already operate, consistent not just with local law but also with international standards for i) CCP activities overall (the PFMI) and ii) CCP recovery.⁴ Any assessment of a CCP's equity for resolution, including the scenarios used, should reinforce international standards, while allowing local authorities to design such a framework in order to promote incentives that support financial stability.

More broadly, financial markets as a whole are better off because central clearing operates for certain instruments, providing market participants with a safe and effective forum to manage their risks, based on transparent prices. But clearing is an enhancement deliberately focused on those specific parts of financial markets – it is not a backstop for the system in its entirety.

³ This could also affect the cost of clearing (and therefore access to it); and also incentives to invest in the CCP offering and its continuing development.

⁴ Especially the importance of avoiding premature moves to resolution, before the completion of actions governed by the CCP's rulebook, in fulfilment of market expectations.

Please note that, in replying to this consultation, we have focused on answering a limited number of questions, where we believe latent issues exist.

Step 1: Scenarios

1. What are your views on the scenarios presented for evaluating existing tools and resources?

Scenario development is already embedded in CCPs' practices for managing default and non-default losses (NDLs, whether or not the CCP's members bear some responsibility for them), all in a framework of enterprise-risk management.

In any scenario planning, it is appropriate to recognise how much work has been done to enhance the resilience of CCPs since the 2008 financial crisis (in which CCPs performed as expected) and how CCPs have robustly navigated market stress time and time again. As noted above, current international guidance sets out standards for maintaining minimum amounts of CCP equity, as well as other financial resources for addressing clearing member defaults. These standards remain valid, which makes the purpose of the scenarios proposed in the draft guidance unclear. The scenarios appear to form the basis for adjusting the treatment of a CCP's equity, but under current international guidance, a CCP's equity is not – and should not be – expected to address extreme but implausible market conditions.

As regards non-default losses (NDLs), the consultation does not seem to acknowledge the ex ante measures that a CCP can take to render these implausible as a trigger for resolution.⁵

Notwithstanding the point above about implausible scenarios, we agree (with our emphasis added) that “the resolution authority should recognise that the circumstances leading to a CCP resolution are likely to **be beyond the extreme but plausible market conditions for which a CCP should hold sufficient prefunded financial resources.**” Along these lines, we note that, for default losses to cause enough damage to a CCP that the question of resolution became relevant, the state of the world would have to be significantly worse than it was in 2008. Measures taken since then in relation to bank recovery/resolution and bank capital in principle mean that there is more of a cushion. By definition, therefore, it would take a bigger shock than that generated by banks' activities up to 2008. This would almost certainly be accompanied by very high levels of uncertainty, making any forecasting of limited value and putting a premium instead on the procedures and organisation needed to allow prompt, targeted action based on facts and circumstances at the relevant time.

In summary, the WFE recommends that the purpose of any proposed scenarios be framed more carefully, while aiming at those that are the most likely to lead to CCPs' resolution. Their identification and assessment should not be at the expense of the flexibility for a CCP's local supervisors to act based on careful assessment of the facts and circumstances of the CCP's distress.

2. Are there additional considerations that should be included in the guidance?

⁵ See June 2020 [WFE industry guidance on non-default losses](#)

Yes.

By way of context, the WFE believes that to correctly frame CCP resolution, it is necessary to consider fundamental incentives and how they are addressed.

The WFE's current work programme on CCPs is focused primarily on such incentives in and around central clearing. In the course of this, we have observed that banks' natural incentive is to walk away from financial commitments where it is their own commercial interest, which can be particularly true when uncertainty is high. As with other behaviours, this may be rational for each of them individually but is demonstrably dangerous at the macro level, when all are doing the same.

CCPs, by contrast, perform a distinct and arms-length role that directly addresses this 'contract-incentive' problem, while working closely with market participants and other stakeholders, notably supervisors. CCPs operate a 'win-win' mechanism that maximises discipline among banks and other market participants in relation to commitments they have undertaken (whether in pursuit of trading profits or hedging). They adopt the principle of 'Trust but verify!'; and achieve that verification by saying 'Show us the money!', ie, requiring pre-funded collateralisation of risks.

Market participants willingly agree to such commitments (ie, providing up-front financial backing for their risk positions, with some mutualisation), because CCPs make possible two desirable outcomes that are not otherwise achievable: 'continuity of contract'; and – a unique benefit – multilateral netting, which reduces the size of their exposures and balance sheet. Moreover, the system as a whole also benefits, from i) greater confidence in the ability of the risk-transfer market to function and ii) the simultaneous reduction in risk exposures across the market as a whole.

Similarly, in the bilateral (non-cleared) OTC derivatives markets, participants have had to create a mechanism that stops a trader from 'cherry-picking' – attempting to repudiate losing trades while simultaneously pursuing profitable claims. Specifically, the ISDA Master Agreement governs the credit relationship between parties, such that they can only pursue a net claim or none at all. This increases certainty for the two parties bringing some modest benefits to the wider system.⁶

CCPs reduce systemic risk even more but, in order to fulfil this mandate in an effective manner, need to have the flexibility to structure their activities to incentivise effective risk management among their participants. It is important that, as a core consideration, any further guidance adopted by the FSB builds on the preservation of these incentives.

Step 4: Identifying gaps

7. What are your views on the considerations for resolution authorities when they identify gaps in resources and tools?

The approach to gap analysis tries to set out how to reconcile a quantum of resources set in advance – in good faith and using such information as is available at the time – with future uncertainty. Unlike risk,

⁶ See Mengle (ISDA, 2010): [Netting research note](#)

however, uncertainty is classically *un*-measurable and therefore does not provide a sound input for fine-tuning of tools and resources, as seems to be envisaged by the FSB.

Nor should the service offering of any one CCP be recharacterised (or be left open to recharacterisation) as a more general systemic support or backstop. As explained in the introduction, CCPs provide targeted service offerings where they act as risk managers for the instrument they clear by acting as a creditworthy counterparty to every buyer and seller and can only do that effectively if there is absolute clarity as to this being its role. There is, in short, a good reason why this role and the responsibilities – of the CCP, underpinned by those of market participants – are defined in advance and in a targeted way (eg, in relation to the default waterfall). Any resource requirements should be focused on those necessary for the CCP to perform its defined, stated role; supporting the incentives that characterise the central clearing model.

The objective of the gap analysis should therefore itself be well defined, in order to preserve important and well understood demarcations of responsibility and limits thereon. In other words, resolution planning should not be used to redefine (or allow the possibility of an ad hoc redefinition of) responsibilities; or to re-write the risk-reward balance, given the overarching importance of predictability of arrangements.

As regards the scale of the (future) uncertainty we refer to above, we note that point ‘viii’, for example, alludes to costs associated with financial instability impacts. The latter may have costs that can be quantified ex-post, but the real nature of the threats is more existential in nature, and the policy approach should be framed accordingly, rather than being driven by a process that promises precision where it is not truly achievable; or is necessarily the most relevant or pressing question.

Treatment of CCP equity in resolution

12. Are the considerations for addressing the treatment of CCP equity in resolution plans sufficiently clear?

In our view, the considerations are not sufficiently clear, in the sense that they are not complete in relation to full NCWOL determination.

As per the FSB 2017 Guidance Section⁷, “*CCP participants (if and to the extent that the resolution authority departs in resolution from the loss allocation under the CCP’s rules and arrangements), equity holders and creditors should have a right to compensation where they do not receive in resolution at a minimum what they would have received if, instead of resolution, the CCP had been liquidated under the applicable insolvency law (‘no creditor worse off than in liquidation (NCWO)’ safeguard).*”

In other words, NCWOL can be understood as a comparison between:

- (1) a **hypothetical (‘counterfactual’) scenario, wherein the CCP would have gone into insolvency/liquidation;** and
- (2) the **actual outcome, after intervention by the RA.**

The Resolution Authority may be subject to NCWOL claims in any case when one outcome (the real-life situation, ‘2’) is worse than what would in principle be expected (under a scenario, ‘1’). It is therefore

⁷ Point 5 of the [Guidance](#), on page 10 (/p14 of the PDF)

important to clarify what is understood by ‘1’, ie, the NCWOL ‘counterfactual’. In this respect, we believe that the FSB 2017 Guidance can be clarified.

The Guidance says (in the same text box cited above): *“for the purposes of determining whether a participant, equity holder or creditor is worse off... than in liquidation, the assessment of the losses [in] liquidation should assume the full application of the CCP’s rules and arrangements for loss allocation.”*

Assessment consistent with the FSB guidance should also take into account two other real-world factors, reflecting the true impact of closing clearing services, ie:

1. for clearing members, among other things, the loss of their contracts and the need to replace them (replacement cost being a major friction in OTC markets and, as such, a major reason for promoting central clearing, after the 2008 crisis); for clients, who may be more directional in their positions, the challenges could be acute; in all cases, the availability of collateral would be likely to decline, while demand for it went up;
2. for CCP shareholders, the loss in value of their shares (which would have zero value, once the closure of the service was announced), with any remaining equity being used to meet outstanding liabilities under the application of the local insolvency law, ie, allowing for the normal ‘friction’ experienced when putting any business into liquidation.

The consideration of these factors ensures that the intent in NCWOL is achieved, ie, to compare the resolution outcome with liquidation and not with a recovery outcome.

Put another way, the resolution-liquidation comparison only makes sense when it facilitates a thoroughly informed determination that is consistent with real-world costs. Anything else would be artificially partial and could introduce incentive distortions further up the chain, relating to recovery and, preceding that, the operation of the default-management waterfall.

Please also note that any compensation beyond what is warranted under the NCWOL safeguard or provided for under an individual CCP’s rulebook (eg, recoveries from the defaulter’s estate) is inappropriate and as such, troublesome to see contemplated in the draft guidance. Not only might it undermine user incentives to actively participate in and commit suitable resources to the default management or recovery processes; it might also expose the resolution authority to ex-post financial claims. Providing compensation as from the exhaustion of the CCP rulebook (ie, the point of recovery) therefore essentially defeats the purpose of the default-management process, by creating an incentive for market participants to push the CCP into resolution. Moreover, as a policy matter, it also creates a perverse incentive for users: namely, to reduce the size of the resources subject to the CCP rulebook (as these loss and position allocation tools are *not* reimbursed).

13. Are there additional factors that resolution authorities should consider when evaluating the exposure of CCP equity to losses in resolution?

The WFE believes that any proposal to shift the immediate burden of a crisis scenario to the CCP’s shareholders prior to resolution, whether by imposing an increase in a CCP’s skin-in-the-game within the default fund or by depleting CCP equity value before resolution, would reduce clearing participants’

incentives to actively participate and contribute to the recovery process. Reducing the solvency of a CCP at a time when it is most needed would render resolution a foregone conclusion.

It bears noting that, in line with existing international and local regulatory standards, CCPs currently maintain financial resources to cover scenarios that address extreme but plausible market conditions. This includes CCP contributions within the default fund, to give further assurance to its participants. CCPs' interests are naturally aligned to the market in seeking overall stability, as their business model is ultimately at stake when the system fails. This is in contrast to the interests of each individual participant, where loss mitigation would be paramount during a crisis.

A deviation from this tested and calibrated framework, which balances competing interests in the interests of sustaining a viable market structure, would create perverse incentives for clearing participants to agitate for a CCP to be placed into resolution (rather than attempting to support recovery), since there would be short-term benefit to each individual participant.