European Association of CCP Clearing Houses

EACH response to the FSB Guidance on Central Counterparty resolution and resolution planning

March 2017

0. Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparties Clearing Houses (CCPs) in Europe since 1992. EACH currently has 20 members from 15 different European countries and is registered in the European Union Transparency Register with number 36897011311-96.

EACH appreciates the opportunity to provide feedback to the consultative document on 'Guidance on Central Counterparty Resolution and Resolution Planning' (hereafter called 'The Guidance').

While the following sections describe our views on the different parts of the consultative document, we would like to make a general comment with regard to the structure of the consultative document. We note that every section of the consultative document includes text inside a box and text outside of it. We understand that the text inside the boxes refers to the Key Attributes[1] although it uses slightly different wording.

Suggestion for the final FSB Guidance

Assuming that the intention of the Guidance is to refer to the FSB Key Attributes and in order to ensure a faithful application of the Guidance, we would kindly request that the text inside the boxes reflects the original one of the FSB Key Attributed, rather than a slightly different version of it.

1. Objectives of CCP resolution and resolution planning

EACH agrees with the main objective set out in the Guidance to ensure financial stability in the market and the continuity of critical CCP functions without access to public funds.

EACH also agrees with and welcomes the FSB's confirmation of the importance of maintaining the incentive structure for all participants to centrally clear and to engage constructively to achieve a successful default management and recovery and so to reduce the likelihood of resolution. CCPs are by design risk management and mutualisation systems. The CCP's waterfall, and within it the default fund, are designed to not only provide a substantial buffer of collateral to cover counterparty credit risk, but also to ensure that the participants in the system have appropriate incentives to manage the risk they bring to the CCP and to participate appropriately in the default management process. **The CCP resolution regime (as well as the recovery regime) must ensure that this incentive structure is maintained**, in order to ensure that the CCP is recovered and (as last resort resolved) in the best and most rapid manner**.** This requires the active participation of all the stakeholders involved and can only be fulfilled by ensuring that **the resolution authorities refrain from intervening until all**

[1] 'Key Attributes of Effective Resolution Regimes for Financial Institutions', FSB, 15 October 2014

recovery options have been deployed; or the CCP has failed to duly implement the recovery measures.

The FSB Guidance should be drafted from the premise that a CCP will have exhausted its full set of recovery tools before the resolution authority formally intervenes. This is important in order to align the FSB's Guidance with the existing international standards for CCPs, the CPMI-IOSCO PFMIs[2], which requires that CCPs prepare and maintain a recovery plan.[3] According to CPMI-IOSCO guidance regarding recovery for CCPs, '[r]ecovery' concerns the ability of an [CCP] to recover from a threat to its viability and financial strength so that it can continue to provide its critical services ***without requiring the use of resolution powers by authorities.***'[4]

We also agree with the CPMI-IOSCO Recovery Guidance that a CCP's recovery tools should create appropriate incentives for participants of the CCP to '(i) control the amount of risk that they bring to or incur in the system, (ii) monitor the [CCP's] risk-taking and risk management activities, and (iii) assist in the [CCP's] default management process.'[5] Recovery tools that impact clearing members and their customers should also be transparent to help clearing members and their customers to measure, manage and control their potential losses and liquidity shortfalls when electing to clear with the CCP.[6] A CCP's recovery tools and recovery plan can only create appropriate incentives and provide transparency if the CCP's recovery plan is not undercut by the Guidance and by the CCP's resolution authority.

Therefore, the possibility of applying the full recovery plan must be the preferred scenario and the rule; otherwise the recovery plan would only be a theoretical exercise to be overridden upon the occurrence of a stress event. Strong and fully applicable recovery plans would avoid the need for entry into resolution. The resolution authority should only intervene at an earlier stage if there is **clear and convincing evidence that there is a risk to financial stability by not stepping in prior to the exhaustion of the CCP's recovery plan.**

EACH also considers it is particularly important **to very carefully consider how access to public funds is included in a resolution regime**, as the potential for public money to be used in CCP resolution would weaken the incentives of clearing members. CCPs are designed in a way to ensure that the CCP operator, the clearing members and the clients support a robust risk management framework. Establishing the right incentives is therefore crucial. The inclusion of public money as a tool of last resort in a CCP resolution regime could result in clearing members adding pressure to shrink the waterfall ex-ante and/or less actively bidding in an auction, with the expectations that tax payers would step in to bail out clearing members for their failure to support active risk management.

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[2] 'CPMI-IOSCO Principles for Financial Markets Infrastructures' (April 2012), http://www.bis.org/cpmi/publ/d101a.pdf

[3] 3.3.8 of PFMIs at http://www.bis.org/cpmi/publ/d101a.pdf

[4] CPMI-IOSCO, RECOVERY OF FINANCIAL MARKET INFRASTRUCTURES § 1.1.1, at 3 (emphasis added) (Oct. 2014), available at http://www.bis.org/cpmi/publ/d121.pdf

[5] *See* CPMI-IOSCO Recovery Guidance at 3.3.7. *See also* 3.3.7-3.3.11.

[6] *See* CPMI-IOSCO Recovery Guidance at 3.3.6.

In addition to the objectives listed in the Guidance, EACH considers it necessary **to avoid unnecessary destruction of value of the CCP**. An effective resolution regime should avoid any unnecessary destruction of the value of the CCP. This is particularly important in the case of critical clearing services, the continuity of which is of great value to the CCP's participants (both individually and mutually), but also more broadly to the wider financial system, not only as a matter of overall systemic impact. If the CCP or a particular service ceased to exist, participants would incur considerable costs due to the loss of their positions (including replacement costs if trades are replaced), impact on their capital requirements, loss of revenue from their client clearing business and overall, impact from the lack of access to the corresponding products going forward. The objective of CCP resolution should more explicitly be to avoid this.

Suggestion for the final FSB Guidance

- We would suggest that the final Guidance **adds as a resolution objective the avoidance of unnecessary destruction of CCP value**.
- We would also suggest specifying in Point 1.1 (i) '**<u>maintaining or</u>** restoring the ability of the CCP to perform critical functions'. This would cover the scenario where the CCP is still able to provide critical functions.
- It is also imperative to amend attribute 3 to reflect the CPMI-IOSCO guidance regarding recovery for CCPs. Our detailed proposal can be found in section 3 below.

2. Resolution authority and resolution powers

2.1. Powers to return to a matched book

We agree that in the context of a clearing member default, one of the primary objectives should be to restore the CCP to a matched book. The factors for determining the tools to be used to return the CCP to a matched book will be dependent on the particular stress scenario threatening the CCP. We agree that in the first instance, and to the extent possible, this should be done by using the actions that are already contractually agreed in the CCP rules and arrangements, such as mandatory auctions, (partial) contracts tear-ups, or otherwise terminating contracts. However, EACH considers it would be inappropriate for resolution authorities to constrain themselves to a defined set and order of tools before they know anything about the circumstances of the stress and market at that time can be known or the CCP's recovery plan can be executed.

EACH considers that should resolution be necessary, the following factors should be considered by the resolution authority in choosing and exercising tools to return the CCP to a matched book:

- **CCP Recovery** – The first factor to consider is whether the CCP has been able to fully perform its recovery plan and use all of its recovery tools. The tools defined in the CCP's recovery plan will normally result in a return to a matched book, prevent further losses and return the market to stability. Where the CCP's recovery plan has not been permitted to run as anticipated then consideration should be given to whether implementation of the recovery tools by the CCP would likely be more successful in returning the CCP to a matched book.

- **Clearing member participation in the auction process** – In order to return the CCP to a matched book and limit the repercussions suffered as a result of the default, CCPs provide incentives to non-defaulting clearing members to participate in the auction of the portfolio – by actively and accurately bidding on the defaulter's positions. Such incentives only work if clearing members believe that subsequent recovery tools and resolution would be more painful than their active participation in the auctions. Therefore, the resolution authority should only choose tools in resolution that incentivise appropriate behaviour in the CCP's auction process, in light of what the CCP has already implemented.

- **Partial/Full tear-up** – These tools should be implemented only after multiple failed auction cycles and after reasonable effort has been made to port the positions of the defaulted clearing member. Multiple unsuccessful auctions help the CCP identify inefficiencies and illiquidity in the market, and indicate that there is no longer an appetite or capacity for the products. Partial tear-up is preferable to full tear-up as it allows the isolation and elimination of a smaller, illiquid market segment while allowing the broader market to recover from the relevant stress event. Partial tear-up enables those contracts for which there is market capacity and appetite to be continued (e.g. 'after the defaults, X% of notional was continued'). Full tear up should be used as a last resort tool, and should be part of the scenario against which the decision to put the CCP in resolution should be made. Partial tear up is one of the least invasive tools available for this purpose. **EACH therefore very much supports the clear distinction made between partial and full tear up** and the fact that both of these tools are based on CCP's rules and arrangements. This preserves the incentives and safeguards put in place in setting up the CCP resilience tools.

2.2. Powers for non-default losses

There are a variety of non-default stresses that could lead to losses at the CCP. Given the heterogeneous nature of such stresses, it is important to give separate consideration to each type of stress.

There are three main types of stress scenario that could give rise to a non-default loss:

- **Investment and custody risks** - The potential losses faced by the CCP as a result of the investment of the resources of the CCP, its clearing members and clients, or as a result of the default of a custodian.
- **General business or operational risks** - The potential losses that could result from events other than the default of a clearing member or those related to investment and custody risks (e.g. defective processes, human error, internal fraud).
- **Uncovered liquidity shortfalls** - The potential losses faced by the CCP in being unable to transform assets in a timely way or transfer assets (collateral and cash variation margin payments) between members. This is particularly the case where the CCP has to enter the markets to cover such shortfalls.

Loss allocation for non-default losses should be **proportional to the level of responsibility of each stakeholder involved** (e.g. CCP owner or CCP user) for bringing risk into the CCP or defining the policies to mitigate those risks. The appropriate tool to allocate a particular non-default loss will therefore depend on the type of loss in question:

- **Capital of the CCP –** In line with the PFMIs and the EMIR legislation, European CCPs hold capital, including retained earnings and reserves, proportionate to the non-default risks that the CCP is exposed[7]. This capital *'shall at all times be sufficient to ensure an orderly winding-down or restructuring of the activities over an appropriate time span and an adequate protection of the CCP against credit, counterparty, market, operational, legal and business risks which are not already covered'* by the CCP's other lines of defence.

  Should it be necessary, a CCP might increase its capital resources through the use of capital preservation tools (e.g. reduction in dividend payments, cost reductions, asset sales), payment of its liabilities in instalments or conversion of its debt into equity (subject to an appropriate agreement between the CCP and its counterparty), or general capital raising from investors.

  CCP capital is appropriate for the allocation of non-default losses for which the CCP is the only entity with the responsibility for creating and managing those risks. European CCPs are well placed to meet such losses and thus ensure continuity of the CCP's critical services and the preservation of market stability.

- **Clearing member contributions** – EACH agrees that shareholders should bear losses related to idiosyncratic processes and procedures put in place by CCP management, such as operational risk (e.g. defective processes, human error, internal fraud). However, EACH members consider that where the clearing members are responsible

[7] http://bit.ly/1Nr5w4l European Market Infrastructure Regulation (EMIR) - Article 16 Capital requirements: A CCP shall have a permanent and available initial capital of at least EUR 7,5 million to be authorised pursuant to Article 14. CCP's capital, including retained earnings and reserves, shall be proportionate to the risk stemming from the activities of the CCP. It shall at all times be sufficient to ensure an orderly winding-down or restructuring of the activities over an appropriate time span and an adequate protection of the CCP against credit, counterparty, market, operational, legal and business risks which are not already covered by specific financial resources as referred to in Articles 41 to 44.

for determining the way in the risks they bring to the CCP are managed, such as directing the investment strategy for their assets (which dictates counterparty credit quality, collateral acceptability criteria, limits etc.), or selecting the custodian at which their assets are deposited or dealing with liquidity related losses (in the cases where the CCP has agreed upfront a detailed liquidity framework with its members) then the CCP should not be held solely accountable for losses associated with such decisions. Instead the CCP should only be responsible for a proportion of such losses At the other extreme, where a fraud was perpetrated by a clearing member, then that clearing member should be solely liable for any losses.

- **Other potential resources** – CCPs may maintain additional resources for the allocation of those non-default losses for which the CCP is the only entity with the responsibility for creating and managing those risks. These **additional resources** include **insurance agreements** which can in some cases be a potential additional resource to address losses from activities that the CCP undertakes.

2.3. Equity in return for contributions to the CCP resolution

A clearing member default should not lead to the resolution of a CCP unless clearing members fail to participate in default management and in recovery. Rewarding such behavior by allocating equity to clearing members in resolution would weaken a CCP's ability to default manage and to recover. The Guidance should be revised to make certain that such behavior should not be rewarded and instead preserve fully the incentives created by the CCP's default management processes and recovery plan.

CCPs are a risk management and mutualisation system designed to ensure that the participants in the system have appropriate incentives to undertake proper risk management and to support an orderly default management process. EACH believes that requiring CCPs to reimburse clearing members for the performance of the default management process or the use of any contractually agreed recovery/resolution tool (such as assessment powers) would fundamentally change the positive risk management features which make CCPs so stable, undermining the incentives of the clearing members to properly participate in the auctions and the broader recovery process. Clearing member reimbursement would severely disrupt the risk management incentives of CCPs as follows:

- **'Ex-ante' incentives** - The potential for clearing member reimbursement could result in the clearing members putting pressure on the CCP to reduce the size of the default fund or lower risk management standards, making CCP stress more likely, in order to attain reimbursement. This would dramatically disrupt the incentive structure on which the CCP is built, where the use of additional lines of defence are designed to be increasingly punitive.

- **'In-a-crisis' incentives** - The potential for clearing member reimbursement would naturally incentivise clearing members against appropriately participating in the default management process (e.g. 'poor' bidding in the auction), unnecessarily prolonging the default management process and increasing systemic risk.

- **Potential obstacle to resolution tools -** providing instruments of ownership to a clearing member would make the commercial sale of the CCP more difficult, as there could be a large number of additional owners for a purchaser to interact with.

- **Ex-post concerns -** providing permanent instruments of ownership with decision-making powers to clearing members involved in the CCP's resolution would mean giving them significantly increased control over the market's risk mutualisation vehicle, thus, undermining successful policy efforts in securing the appropriate level of independence for CCPs' risk management. It is also important to bear in mind the diverse nature of CCP membership (in the commodities markets this can include physical users of the underlying commodity) and whether all of these entities are well placed to exercise the necessary shareholder governance over the operations of a CCP.

The risks to incentives are consistent whether the awarding of claims is at the CCP or the parent of the CCP. Introducing compensation at the parent of the CCP introduces additional concerns, including:

- **Short term effect on incentive structure** - Many CCPs are part of a larger corporate structure, potentially operating a range of financial services which would not be damaged by resolution of the CCP. This would create further incentives for members that may prefer short-term losses in exchange for equity in a group that will maintain many viable businesses after the CCP's resolution. This would clearly affect incentives to effectively participate in the default management and recovery of the CCP as it could be very attractive to wait and be able to claim for equity in the broader group.

- **Longer term effect on financial stability** - This would affect the market structure and create financial stability concerns. Such mechanisms would concentrate the ownership of critical infrastructures in the hands of their users (which was more common before the 2008 financial crisis) and would undermine international efforts to make CCPs appropriately independent from their membership.

In the case of **non-default losses**, as outlined above, there could be circumstance in which the clearing members would be responsible or co-responsible for the losses. In this case, clearing members should **not be granted any sort of compensation**.

The potential for reimbursing clearing members should be clearly distinguished from the potential for shareholders to bear losses, a totally different situation which under certain circumstances could be enforced in line with the FSB Key Attributes.

Suggestion for the final FSB Guidance

- In line with the rationale exposed above, we would strongly suggest that **paragraph 2.15 of the Guidance be deleted or at least limited** to those cases of non-default losses where the clearing member is not deemed responsible or co-responsible.

3. Entry into resolution

As outlined in EACH's response to the FSB's August 2016 Discussion Note[8], the factors for determining timing of entry into resolution will be dependent on the particular stress scenario threatening the CCP. However, unless and until recovery is clearly ineffective or its continued application could result in a greater risk for financial stability, the recovery plan defined by the CCP should be permitted to run as anticipated by the market.

EACH therefore believes that the **timing of entry (or range of timing) into resolution should be defined by reference to** the following considerations:

- **Unsuccessful (or clearly will be unsuccessful) recovery** – Authorities should avoid the presumption of resolution for CCPs or the creation of a defined limit to the CCP's recovery plan. Doing so could arbitrarily truncate, or condemn to failure, the recovery process before the recovery plan has had the opportunity to work properly. A CCP should only be put in resolution once the previously described CCP tools and processes are exhausted or have proven ineffective, or the CCP is *materially* breaching its core obligations as described in the CCP's rulebook (e.g. maintaining the appropriate level of regulatory capital as defined in EMIR). This is reflected in the FSB's existing guidelines on resolution which prescribe that resolution is triggered when '*the recovery tools failed to return the FMI to viability, have not been implemented in a timely manner, or relevant authorities determine that recovery measures are not likely to return the FMI to viability*'[9].

  We understand some authorities may be concerned that intervening too late may result in resolution being less effective. However, we believe this concern is unwarranted as CCPs are required to inform their regulatory authorities in a variety of stress events and throughout the default management process regulators would be kept appraised.

- **Early intervention** – Early intervention should be considered as a **tool of last resort** as it would likely expose taxpayers to greater risk of losses. Early intervention by the resolution authority would contribute to a lack of confidence. The entry by the resolution authority would be viewed as a signal by the clearing members that recovery of the CCP has failed and would deter clearing members from participating in any

[8] http://www.eachccp.eu/wp-content/uploads/2016/10/EACH-response-FSB-discussion-note-on-CCP-Resolution-Planning-October-2016-Public.pdf

[9] 'Key Attributes of Effective Resolution Regimes for Financial Institutions', FSB, 2014, http://www.financialstabilityboard.org/2014/10/r_141015/

further efforts to restore the CCP to a matched book and/or allocate losses resulting from clearing member defaults. Early intervention should only be considered where there exists clear and convincing evidence that allowing the recovery plan to continue would have a detrimental impact on financial stability. Early intervention could potentially create moral hazard which may weaken the CCP's ability to conduct an orderly loss allocation in full and lead to the premature resolution of the CCP. Maximising the likelihood of a private sector recovery arrangement is important in order to avoid a shift of responsibility to the public sector.

If early intervention occurs, it is critical that the legal responsibility of either the CCP management or the resolution authority is clear at all times to avoid a situation whereby the CCP's management would find itself only partially independent but legally accountable for the decisions made.

In addition, in those jurisdictions where early intervention may correspond to CCP's supervisory authorities, rather than to resolution authorities, it would be of utmost importance to ensure proper coordination, mutual cooperation and information sharing among authorities, with regard to the powers and tools respectively entrusted to them. EACH believes that the CCP should be directly involved in such coordination and information sharing.

It is also critical that, if the resolution authority continues to execute the CCP's rulebook, as suggested in paragraph 2.2, the appropriate NCWO counterfactual is considered. Paragraph 5.2 suggests that the authorities' responsibility for considering the NCWO only begins once they've deviated from the CCP's rulebooks, but 2.2 does not explicitly require deviation from the rulebook for the resolution authority to intervene in the execution of the recovery plan. Whilst we do not see why the resolution authority would intervene without the intention of deviating from the CCP's rules and recovery plan, we ask that the FSB make it explicitly clear that anytime the resolution authority intervenes into the CCP, an event that should be rare and only in the interest of broader market stability, the resolution authority is required to consider the NCWO counterfactual.

- **Financial stability concerns** – The resolution authority should have to demonstrate that there is clear and convincing evidence that entry into resolution prior to the exhaustion of the CCP's recovery plan would result in greater financial stability (e.g. to avoid a contagion effect across multiple CCPs). We would expect this to be the core driver for intervention. In those jurisdictions where early intervention may correspond to CCP supervisory authorities, rather than to resolution authorities, coordination and mutual cooperation and information sharing among authorities, with regards to the powers and tools respectively entrusted to them, becomes of the utmost importance.

We would like to express our reservations with regard to the list of 'Potential indicators relating to default losses' included in paragraph 3.4. In particular, **we oppose the use of criteria 'iv)**

CCP's participants no longer have confidence in its ability to manage risks effectively'. We consider that this proposed criterion is subjective, and allows for an arbitrary entry into resolution even before the CCP's resilience tools have been affected by a default or non-default loss. It would therefore bring uncertainty as the entry into resolution would be disconnected from CCP resilience and recovery tools, based on merely the opinion of CCP's participants which may not be as independent as that of public authorities. Under early intervention, the resolution authority should do something different to what the CCP would have done under its rulebook.

Suggestion for the final FSB Guidance

Further to the reasons detailed above, we propose the following drafting amendments to attribute 3 to address this point:

> Entry into resolution should be possible when a CCP **has exhausted its recovery plan** ~~is, or is likely to be, no longer viable or no longer able to meet applicable legal or regulatory requirements on a continuing basis, and has no reasonable prospect of returning to viability within a reasonable timeframe through other actions that could be taken by the CCP (that do not themselves compromise financial stability)~~. The resolution authority, in consultation with other relevant authorities, should have the power and practical arrangements to place a CCP into resolution promptly and if necessary prior to the end of the CCP's existing recovery and loss allocation arrangements where:
>
> > (i) recovery measures available to the CCP, including the use of its available assets and default resources and the application of any loss allocation rules have been exhausted and failed to return the CCP to viability and continuing compliance with applicable legal and regulatory requirements, or are not being implemented in a timely manner; or
> >
> > (ii) the relevant oversight, supervisory or resolution authority determines that **there is clear and convincing evidence there is a risk to financial stability by not stepping in prior to the exhaustion of the CCP's recovery plan.** ~~the recovery measures available to the CCP are not reasonably likely to return the CCP to viability within the timeframe required to enable continued compliance with applicable legal and regulatory requirements, or that they are otherwise likely to compromise financial stability.~~

Regarding the **'Potential indicators relating to default losses'**, we would also like to express our concerns with regard to criteria iii) under paragraph 3.5. We believe that the way it is currently drafted, the criteria could result in the CCP being put in resolution for a relatively minor issue and therefore unduly destabilising the market. We would therefore suggest slightly amending the paragraph to clarify the CCP's failure to comply should be significant and its scope should be limited to essential regulatory requirements.

Suggestion for the final FSB Guidance

To slightly amend indicator iii) under paragraph 3.5 to clarify that 'the CCP ***significantly*** fails …'.

Finally, regarding ´*Cooperation between relevant authorities in the lead up to resolution*´, and in addition to the previous specific comment on early intervention, EACH very much welcomes the FSB approach on the necessity of cooperation and information sharing among authorities. However, we are of the opinion that **CCPs should be directly involved in such cooperation and information exchange**, in all the recovery and resolution process, but especially in the lead up to resolution, where CCPs´ recovery plans might be deployed. A solid and effective cooperation and communication scheme between CCPs and authorities, before and during the crisis, would definitely contribute to the creation of an environment of market confidence beneficial for the main objectives of maintenance of CCPs core business and clearing services and preservation of the financial stability as a whole.

Suggestion for the final FSB Guidance

In line with the above, to slightly amend paragraph 3.6 as follows: *'In order to enable resolution authorities to act promptly, relevant authorities, including the supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes, if any, involved in cooperative arrangements and Crisis Management Groups (CMGs) for the CCPs concerned,* ***as well as CCPs,*** *should cooperate (…)'.*

4. Allocating losses to equity holders in resolution

In the case of **default losses**, we do not think there is a need to write down the CCP owners' equity as, with the appropriate tools, we consider that CCPs are able to fully allocate losses to their members.

A clearing member default should not lead to a resolution of a CCP unless clearing members fail to participate in the default management process and in recovery. Rewarding such behaviour by allocating remaining losses away from clearing members would weaken a CCP's ability to default manage and to recover. The Guidance should be revised to make certain that such behaviour is not rewarded and instead the incentives created by the CCP's default management processes and recovery plan are fully preserved. It is critical that no equity write downs be permitted until a CCP exhausts all available recovery tools and clearing members meet all of their obligations.

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Suggestion for the final FSB Guidance
In the unlikely case that the appropriate tools are not sufficient, we would request **the Guidance to clarify that equity write-down should only occur once all recovery measures have been applied.**

The same may hold true for the type of **non-default losses** for which clearing members are solely or jointly responsible (e.g. where the clearing members are responsible for determining the way in which the risks they bring to the CCP are managed), as discussed above under point 2.2 in this document.

Furthermore, **minimum capital requirements** under relevant legislation should be applied to absorb losses only as prescribed by such relevant legislation. The minimum regulatory capital is typically aimed at protecting adequately the CCP against credit, counterparty, market, operational, legal and business risks which are not already covered by specific financial resources. Besides, some jurisdictions impose the obligation to maintain regulatory capital at all times sufficient to ensure an orderly restructuring of the activities or, in its case, an orderly winding-down. In case of resolution of a CCP, the amount of the minimum capital should be used for the exclusive purpose of covering the winding-down costs (including, for instance, indemnification to employees). Should there be any excess after the winding down, excess capital would not be returned to shareholders, but applied to absorb losses not yet covered by the application of other resolution tools. This protection of minimum capital requirements should be pointed out in the final FSB Guidance.

Suggestion for the final FSB Guidance

To clarify in the Guidance that minimum capital requirements should only be used **in accordance with the relevant legislation**.

For **other non-default losses**, and further to the use of the CCP's capital, the CCP's shareholders would be subject to a write down of their equity as per a normal corporate insolvency.

Suggestion for the final FSB Guidance

We therefore propose the FSB Guidance to refer to **normal corporate insolvency** under paragraph 4.2.

5. No creditor worse off safeguard

Default losses – Definition of an adequate counterfactual

While we consider that compensation may create perverse incentives, as it disincentivises participation in default management and recovery measures, we generally agree with the main principles defined in this section of the consultative document.

Assuming that the primary driver for the intervention of the resolution authority is financial stability concerns, EACH would appreciate further clarity in the Guidance with regard to how the NCWO principle would be applied in a way that captures the benefits of preserving financial stability.

Suggestion for the final FSB Guidance

EACH believes that the Guidance should include as the **adequate counterfactual** for default losses a combination of:

- **Application of the rulebook and some resolution tools** - It is important that the counterfactual assumes, at a minimum, the full application of the CCP's rules and arrangements and some resolution tools, assuming that members fulfilled their contractual assessment rights and gains haircutting/contract tear-up were applied. This ensures legal certainty for the resolution authorities, as well as transparency for clearing members. Likewise, we support the need to make clear and transparent which resolution powers are included in the counterfactual.

- **Value of continuity adjustment** – NCWO should in addition be judged relative to the desired level of continuity. If participants feel that the burden imposed by loss allocation necessary for (partial or full) continuity is too high, the CCP should be closed. If the problem is rather that the existing available resources are too low to achieve (desired) continuity, then loss allocation and tool usage should be broadened to enable this. Under the second scenario, participants should not be able to claim, since the increased continuity was in their favour.

Applying this counterfactual would have the following advantages:

- Protection of resolution authorities - Counterfactual captures the benefits of preserving financial stability potentially broad enough to allow resolution authorities to enforce resolution without the potential for immediate claims that could prevent a successful resolution.
- Legal certainty for the resolution authorities - It allows authorities to focus on promoting financial stability by employing the relevant resolution tools for

unprecedented market conditions, without being constrained by concerns around legal claims.

- The addition of a value of continuity element is 'the right answer' in that claims are permitted if authorities enforce continuity beyond what the market wanted.
- Value of continuity can be tailored per CCP / sub-CCP based on the desired metrics that value it.

It can also be applied in practice: if participants judge that the value of continuity determined by the resolution authority is too high, they can achieve a similar protection by simply defaulting against the CCP.

Default losses – Clarification on the draft FSB Guidance (paragraph 5.1)

Suggestion for the final FSB Guidance

While we understand the reference to the full application of the CCP's rules included in paragraph 5.1 of the draft guidance we would appreciate further clarity with regard to the meaning of the sentence 'arrangements and any other contractual agreements subject to the applicable insolvency law'. We believe as it stands it may be seen as too vague and could bring to misinterpretation.

Non-default losses

The appropriate NCWO counterfactual for a resolution scenario involving non-default losses is the applicable **insolvency regime**, assuming the prior application of any relevant loss allocation arrangements for non-default losses that exist under the CCP's rulebook. However, we consider that the counterfactual should clearly include the full application of CCP's rules and arrangements, as it is the case for default losses. Indeed, the CCP's rules and arrangements might include some loss sharing arrangements as for example in the case of losses due to investments determined by the clearing members (see comments on section 3.2).

6. Financial resources

We appreciate the FSB's allowance of **'an appropriate timeframe'** with regards to replenishment of regulatory resources in the Key Attributes on page 12 of the consultation. Particularly in the unprecedented and extreme scenarios under consideration where the CCP has accessed some of its default fund 'cover 2' required resources which are funded by clearing members, it may be detrimental to the goals of financial stability to require replenishment of these funds immediately upon re-establishing the matched book. Many CCPs have a 'cooling off' period in their rulebooks to allow clearing members to recover from a market stress before replenishing their contributions to the default fund. An event that would impact these clearing member contributions would be beyond extreme but plausible and it is reasonable to allow for a defined and limited time before calling for these funds. In a recovery scenario where a matched book has been re-established and the recovery of the CCP and market has clearly been successful, it is appropriate that the regulators consider allowing a degree of flexibility in defining the timeframe under which the CCP's resources should be replenished and we appreciate the FSB's acknowledgement of this flexibility.

7. Resolution Planning

We generally appreciate the references the content of the resolution plans, such as the need to take into account the *'how the plan would address intra-group dependencies, interoperability arrangements and links with other FMIs, such as exchanges and central securities depositories (CSDs), whether in the same group as the CCP in question or not'.*

We would like to express our concerns with regard to point 7.5(v) to include in the resolution plan a **rigid sequencing of resolution tool**. In the event where such sequencing is defined, we believe that it should be indicative and that the resolution authority should not be bound by such sequencing.

8. Resolvability assessments and addressing impediments to resolvability

When adopting measures to address impediments to resolvability, authorities should observe the corresponding regulatory requirements applicable to CCPs under the relevant jurisdiction. Alignment between regulatory requirements and resolvability tools is necessary.

We appreciate the FSB's consideration of 'the soundness of operations at the CCP' when considering its resolvability. This rightly acknowledges that the resolution of a CCP is a tail-of-a-tail event, occurring only three times in modern financial history, all of which occurred before rigorous and prudent risk management standards were applied universally to CCPs and the members that utilise their services. It would therefore be inappropriate for the resolution authority to jeopardise existing operational, structural or legal arrangements of the CCP to prepare for such an unlikely event, particularly where the supervisory authorities have already conducted appropriate review and approval of the CCP's business, structure, operations and governance. **Any measure that would reshape a CCP's structure, operations, governance or business model would impose costs on the CCP's stakeholders and must therefore be subject to a proper cost benefit analysis to ensure their proportionality**.

Where the CCP has been authorised and is in compliance with prudential regulatory obligations, including regular reviews of changes which are required by most local regulators, the execution of their business does not require further evaluation. These regulatory standards, in line with international standards, have been developed to create a common set of best practices that EACH members are committed to implementing. These regulatory standards already provide a sound basis to ensure the ability of a CCP to be successfully resolved.

In addition, the FSB guidance proposes resolvability assessments which cover key elements that have already been reviewed and approved by the authorities during the authorisation process of the CCP. Requiring the CCP to perform significant changes to these same elements may contradict previous processes. We consider there to be conflicts between the interests of the supervisory authority in fostering a CCP that operates efficiently in the interests of its direct stakeholders (clearing members, customers and the banking and payment systems) and the interests of a resolution authority concerned about minimizing the costs of failure without regard to ongoing operations. We think that a proper cost benefit analysis is likely to demonstrate that empowering a resolution authority to reshape a CCP's structure, operations and governance, to facilitate resolvability in anticipation of a failure is unwarranted and will impose costs on the CCP's stakeholders. There being no evidence that resolution will be more complicated or costly in cases where a CCP is operating solely in accordance with current CCP structures, operations and governance.

In particular, the potential for an authority to require that certain products be separated during resolution could create breaks in liquidity pools and netting arrangements. It could further impose significant costs on clearing members suddenly faced with multiple requirements to fund additional default funds. This would materially impact market participants and their liquidity, making clearing more difficult and expensive. This could create further pressure on the accessibility of critical clearing services for smaller firms and fragment markets unnecessarily. The scenario envisioned of a CCP resolution is unprecedented and the potential resolvability of a CCP is an extreme event beyond anything remotely considered plausible. CCPs and the appropriate regulators have developed and support clearing arrangements that suit their markets and provide robust risk management solutions. It would not be desirable to split the CCPs in multiple individual legal entities when proper segregation within the CCP (for instance with separate default waterfalls for each clearing service) would ensure its resolvability. While resolution would apply at the legal entity level, the resolution authority would have the ability to deal with the different clearing services separately.

9. Crisis Management Groups

CCP resolution will be most effective if it is **led by the resolution authority of the jurisdiction** in which the CCP is established.

The efficient resolution of a cross-border CCP will only be facilitated if the relevant jurisdictions have taken a consistent approach to the development of CCPs recovery and resolution regimes.

In the case of resolution of a CCP that belongs to a group, the resolution authority should step in at the lowest possible level of consolidation. Other FMIs in the group might not be affected. The resolution authority should always be mindful of the impact of their actions on the broader group to which the CCP belongs. When it comes to defining the resolution plan ex-ante, EACH believes that the resolution authority should closely interact with all of the relevant authorities involved in the supervision for the CCP and the appropriate authorities for the stakeholders that will be impacted by the resolution of the CCP. We think that cooperation mechanisms and information sharing processes that will be triggered by a CCP resolution should be defined and tested ex-ante (e.g. authorities' fire drills).

However, at the time the resolution plan needs to be implemented, the resolution authority should be empowered to take decisions and act swiftly.

EACH believes that the full suite of powers available to the resolution authorities should be agreed ex-ante and disclosed publicly. This would ensure that all participants potentially involved in resolution (e.g. clearing members) will be able to build their own recovey plans and understand their potential liabilities. In addition, regulators in many jurisdictions will need to be fully aware of these powers, and in which circumstances they can be employed.

We however understand the need for some flexibility in the order and magniture in which the tools should be use by the resolution authority.

10. Cross-border effectiveness and enforcement of resolution actions

EACH believes that the Guidance correctly outlines the need for cross border cooperation given the fact that actions in one jurisdictions could impact another.