

BBA Comments on FSB Guidance on Central Counterparty Resolution and Resolution Planning Consultative Document

13 March 2017

Introduction

The BBA is pleased to respond to the FSB's proposed "*Guidance on Central Counterparty Resolution and Resolution Planning*". The BBA supports the work of the FSB, the Committee on Payments and Market Infrastructures (CPMI), the International Organisation of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS) to enhance and strengthen the resilience, recovery and resolvability of central counterparties (CCPs). We are particularly pleased that the FSB has taken on board a number of comments that ourselves and other associations have made in the past, including responses to the FSB's August 2016 Discussion Note "*Essential Aspects of CCP Resolution Planning*".

The BBA believes that the importance of CCPs has increased since the 2009 mandate to clear OTC derivatives. As such, the importance of ensuring CCPs have suitable and effective recovery and resolution regimes has also grown, and we welcome the approach taken by the FSB thus far. However, we have a number of concerns regarding certain aspects of the Consultative Document and recommend these be considered by the FSB ahead of any final guidance publication.

We have grouped our comments by the section of the Consultative Document to which they refer:

Section 1 – the overall objectives of CCP resolution and resolution planning

The BBA believes in the continuity of a systemically important clearing service. This is in order to maintain the stability of the financial markets, and to avoid any major disruption to the financial market infrastructures (FMI) and the wider markets. We are concerned that following any disability of payments and settlements, it would take an inordinate length of time to restore order, confidence and stability.¹

Section 2 – the powers that resolution authorities should have to maintain the continuity of critical CCP functions, return the CCP to a matched book and address default and non-default losses

On the powers used by resolution authorities (RAs) to maintain critical CCP functions, return to a matched book and address default/non-default losses, we reiterate the following points:

- a) The BBA supports the use of partial tear-up to be used by regulators to establish a matched book and believes this should be deployed only as a last resort (doing

¹ The example of CCP resolution action taken following the collapse of the Hong Kong Futures Exchange clearing house in 1987 demonstrates how significant the impact of CCP failure can be.

otherwise would likely cause further volatility to the financial markets). There should be explicit guidance provided on the price discovery mechanism for performing a partial tear-up. Members affected by the partial tear-up should be compensated. Any losses incurred through a partial tear-up should be allocated via loss allocation tool(s) such as variation margin gains haircutting (VMGH).

- b) We believe the use of a full tear-up of a systemically important clearing service would be extremely destabilising to the market. Given that there are only one or two CCPs located within any particular jurisdiction, it would be difficult to claim that any particular clearing service was not systemically important.
- c) We recommend against the use of forced allocation in recovery or resolution, even as a last-resort tool, as we believe this would prove to be destabilising to the market. If members are requested to take up positions which they initially did not want to take due to their inability to risk manage these positions, we believe the only plausible outcome is an increase in market turbulence.
- d) We believe it is important for both regulators and authorities to require the standardisation of CCP rule books, with aligned standards that are enforceable within all relevant jurisdictions. This would include setting out a minimum requirement for the CCP's risk waterfall.
- e) Although we regard VMGH as an acceptable tool (though we emphasise our belief it is not a desirable tool), as it helps a CCP to manage losses resulting from a defaulted portfolio or a distressed member in a market crisis, we believe VMGH should always be a last-resort tool by the resolution authority and should be used in a limited manner if necessary (i.e. for one day only). VMGH should not be used in recovery at all. Additionally, we note that VMGH may not be an appropriate tool for certain products (e.g. cash securities, repos) and recommend that the guidance explicitly exclude such products for VMGH application. Further, members affected by VMGH should be compensated.
- f) We are strongly opposed to the haircutting of IM. Such a resolution tool would almost certainly act as a disincentive for members from clearing their trades through CCPs going forward, and we recommend that it be ruled out clearly and categorically as an available tool.
- g) Non-default losses should not be allocated to clearing members. Instead, we recommend that CCP equity be used to absorb the non-default losses in their entirety. CCP capital should be right-sized to ensure that it is sufficient to absorb any type of non-default losses.
- h) Section 2.9 references the RA having the authority to make a cash call to the CCP. We believe that members should not be required to make any cash contribution in excess of 1x DF assessment across recovery and resolution. As noted in the industry feedback to the CPMI and IOSCO guidance, assuming that a CCP holds "cover 2" resources, additional resources equal to one times the default fund would cover defaults of members that would cause the four largest losses. Based on CPMI and

IOSCO public quantitative disclosures for CCPs that clear listed products, the largest member loss is actually two to three times the size of the second largest member loss. In these situations, additional resources equal to one time the default fund would cover losses from four additional members (i.e., six members in total). Additionally, based on the quantitative disclosures, losses from the top five members account for 50% of total potential losses. Losses beyond these would suggest extreme market moves and/or members failing at a rapid and unprecedented rate.

- i) Section 2.15 notes compensation to members who have suffered losses in excess of their obligations under the CCP's rules and regulations. The BBA disagrees with the approach that compensation should be provided only if loss allocation is in deviation to CCP rules. Clearing participants that suffer losses beyond the CCP's funded (i.e., default fund) and unfunded default resources (i.e., capped assessments), in either recovery or resolution, should receive senior claims as compensation.

Section 3 – the potential indicators of circumstances that could lead to a determination to trigger resolution

The BBA supports the guidance in relation to point of entry for the RA. The BBA has no further comments, but refers to and supports the response of ISDA to the Consultative Document.

Section 4 – the treatment of equity of existing CCP owners in resolution

The BBA supports the approach suggested by the FSB. The BBA has no further comments, but refers to and supports the response of ISDA to the Consultative Document.

Section 5 – the application of the “no creditor worse off” safeguard and determination of the insolvency counterfactual

We believe the “no creditor worse off” (NCWO) safeguard is critical, and generally support the approach taken by the FSB. The counterfactual for both a default and non-default loss is, in effect, the liquidation or termination of the CCP “or relevant clearing service” under any applicable insolvency law and assuming the “full application of the CCP's rules and arrangements and any other contractual agreements subject to [such] applicable insolvency law.” We assume, but would appreciate confirmation from the FSB, that the counterfactual would be that, at the point in time the resolution authority intervenes, insolvency proceedings, rather than resolution, are commenced with respect to the CCP.

If this assumption is correct, then we would note that the relevant insolvency-related provisions of the major global CCPs provide for closeout netting of all transactions the CCPs are parties to. Such provisions do not contemplate that the CCPs (or their insolvency officials) would continue to engage in recovery measures. Instead, the goal would be to promptly liquidate the CCP in its entirety. In this regard, we observe that it would not be appropriate to assume a clearing service of a CCP could alone be liquidated. We are not aware of any current insolvency regime that would provide for the liquidation of a business division of a CCP, rather than the entire CCP. Moreover, even if there were such a regime,

the relevant CCP's closeout netting rule would provide for the liquidation of all transactions of the CCP across all its clearing services.

The BBA does not believe it is appropriate for limited recourse provisions to apply in the event of a CCP's liquidation in insolvency. Limited recourse provisions are designed to prevent an insolvency of a CCP, and if the CCP were insolvent it would be evident that its limited recourse provisions had failed to achieve their primary purpose. Additionally, limited recourse provisions increase the likelihood that recoveries or NCWO compensation is paid to a CCP's equity without participants being reimbursed losses they have suffered.

Members' commitments to meet assessments should terminate immediately and automatically upon the commencement of insolvency proceedings of a CCP. If a CCP was being liquidated, it would make little sense to call upon surviving members to fund into an insolvent entity.

Section 6 – the assessment of the adequacy of financial resources in resolution, including elements that the FSB should consider in future work on the quantum of resources for purposes of resolution

The BBA supports the additional work required for determining financial resources in resolution, and in particular agrees that more work is required to determine CCP capital (also considering adequacy of capital to absorb non default losses) and any additional resources required for recapitalisation, along with the replenishment of CCP capital in the default waterfall.

In relation to the recovery of temporary funding from clearing members, we would need more clarification as to how it will work before commenting either way, and note that it could aggravate the stress to CCPs. In any case, a cap on assessments should not be breached on account of recovery from clearing members.

The BBA supports the remainder of the approach suggested by the FSB and has no further comments to make; we refer to and support the response of ISDA to the Consultative Document.

Sections 7 and 8 – the aspects of resolution planning and resolvability assessments

The BBA strongly supports resolvability assessments and the ability of RAs to make changes to CCP rules. However, any such change should be subject to appropriate member review and an approval process. We note that further work is required to address the impact on interconnected FMIs of these assessments, including any arrangements for interoperability.

The BBA supports the remainder of the approach suggested by the FSB and has no further comments to make; we refer to and support the response of ISDA to the Consultative Document.

Sections 9 and 10 – cross-border cooperation and the cross-border enforcement of resolution actions

Whilst the BBA supports the approach taken by the FSB in defining Crisis Management Groups (CMGs) and outlining where these should be used, we believe that the points made on information sharing should be expanded to refer to clearing members and other CCP users.

The BBA believes that in order for CCP resolution planning to be as effective as possible, regulators, clearing members, their clients and indirect clients must all have visibility into a CCP's resilience, recovery and resolution framework. Such transparency would not be served by restricting information relevant to the resolution of a CCP to the members of a CMG, and we would recommend that the FSB clarify it is not their intention to prevent clearing members from accessing such information.