

***FINANCIAL STABILITY BOARD (FSB) CONSULTATIVE DOCUMENT ON
“GUIDANCE ON FINANCIAL RESOURCES TO SUPPORT CCP RESOLUTION
AND ON THE TREATMENT OF CCP EQUITY IN RESOLUTION”***

The Advisory Committee of the CNMV has been established by the Spanish Securities Market Act as the consultative body of the CNMV. This Committee is composed by market participants (members of secondary markets, issuers, retail investors, intermediaries, the collective investment industry, etc.) and its opinions are independent from those of the CNMV.

INTRODUCTION

The Spanish CNMV Advisory Committee welcomes the FSB Consultative document about “Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution”, dated 4th May 2020.

This document develops draft guidance based on the concepts included in the FSB Discussion Paper of 15th November 2018, that was subject to public consultation.

The scope of the guidance refers to two main topics:

- Financial resources for CCP resolution. Provides draft guidance on assessing the adequacy of financial resources needed to absorb losses and to cover other costs in resolution.
- Treatment of CCP equity in resolution

Please find below the answers given by the CNMV Advisory Committee to the questions raised in the public consultation.

Nevertheless, it is important to make some previous remarks, in terms of proportionality in the recovery and resolution regimes and measures proposed by Financial Authorities.

Central clearing of standardised OTC derivatives is one of the key pillars of the G20 commitment, and CCPs play a crucial role in contributing to a sound and safe financial system as risk managers. We would like to highlight the fact that there are many CCPs whose main core activity is focused on Equities, Fixed Income securities or ETDs clearing. We would like to point out that this fact should be considered in the standards setting, in order to achieve a proper and balanced measures.

Additionally, in our view, it is key to review the factors that determine the qualification of a CCP as systemically relevant. The CCP size, the CCP members’ and cleared

instruments international impact and the importance of the OTC derivatives clearing in the CCP, should be the main relevant characteristics to be considered.

When the need to centrally clear OTC derivatives arose, the service was built around of using the same infrastructures that had so solidly managed any of the crisis, self-containing any default occurred and avoiding by far any systemic spread and any recourse to public aid. The new activity to centrally clear OTC derivatives has meant that a great amount of bilateral and perhaps unmeasured exposures have moved into the CCP space. While this move represents an improvement in the resilience of the whole system due to the safeguards that come with centralized clearing, it inevitably shows that CCPs role is increased and possibly stressed, but it is relevant to note that the increase in exposures for CCPs has not been evenly distributed, with the majority of the move to central clearing of OTC derivatives going to a few giant CCPs (and even then within specific ring-fenced segments) while smaller (and some larger) CCPs have continued their usual business in ETD or securities clearing without any additional reason to have concerns about their capacity to cope with a stressed scenario.

PART I. FINANCIAL RESOURCES FOR CCP RESOLUTION

Step 1: Scenarios

Q1. What are your views on the scenarios presented for evaluating existing tools and resources?

The CNMV Advisory Committee agrees, in general terms, with the identification of the different scenarios that must be considered by the resolution authorities in the recovery planning exercise and appreciates that some of the suggestions given in the November 2018 consultation process have been reflected within the principles.¹

Nevertheless, there are some remarks that should be highlighted:

a) Anticipated resolution decision

One of the scenarios identified for both default and non-default losses, consists of the decision of the resolution authorities to initiate the resolution before some of the arrangements or tools under the CCP's recovery plan are applied. (Points 1.1. (iv) and 1.2. (v)).

While the rest of the scenarios identified depend on external factors and on the successful or unsuccessful result of the recovery measures, this scenario depends on the decision of the resolution authority to initiate the resolution phase before the completion of the recovery phase or even before the beginning of the recovery phase. The CCP may still be in the previous phase of default management process when the decision of the resolution authority is adopted.

¹ Such as do not consider scenarios which imply non-fulfilment, not only of CPMI-IOSCO standards but also with mandatory legal regimes applicable to CCP's, given the existing context of on-going and complete supervision. As well as the ones that imply legal unenforceability.

In this respect, it has to be highlighted that internal CCP's rules include and detail risk and default management procedures, that rely in sound risk management, collateralisation of all risks and the eventual mutualization of losses to retain them within the CCP.

In addition, the complete scheme set up by CCP's is carefully built up to maintain a comprehensive incentive scheme for clearing members to participate and contribute in the recovery measures to be adopted by the CCP in a financial stress event. In most circumstances that should be enough to address the potential loss situation. CCP's and its rules are regulated and supervised by public authorities so that the whole regulatory measures in place contribute to the safe and sound functioning of the CCP.

For those reasons, resolution authorities should not adopt resolution measures and use resolution tools before all the default management procedures and, after them, the recovery measures of the CCP have been activated and fully deployed their effects in accordance with their respective recovery plans, which must have already identified the corresponding hypothetical default and non-default loss scenarios. The loss scenarios hypothetically leading to resolution should be coherent with those anticipated in the recovery plan of the CCP. This way to proceed will also preserve the incentive scheme for clearing members to participate, first in the default management process by the CCP and afterwards, the case being, in the recovery process. This implication by clearing members is crucial for the protection of the CCP's and the critical services provided by the CCP and would result in greater financial stability and prevent and avoid a contagion effect across multiple CCPs.

b) Suspension of clearing mandates

We would suggest to consider the suspension of clearing mandates and the consequences that may be associated to it as an scenario that may lead to a CCP resolution or as a tool that may be used within the resolution toolbox. A suspension of a clearing mandate could provoke that clearing members would be discouraged to take part in the recovery process. It would be interesting and useful to clarify how could it work within the resolution framework.

c) CCP's shareholders do not support CCP's recovery actions

Among the non-default loss scenarios, reference is made to the hypothetical situation where the CCP's shareholders do not cover the CCP's non default losses that are not allocated elsewhere and/or are unwilling to recapitalize the CCP, irrespective of whether there is a contractual commitment, parental guarantee or similar arrangement to provide resources or not. (Point 1.2. (iv)).

The CNMV Advisory Committee considers that this scenario should only be contemplated when there is a commitment, guarantee, or similar arrangement to make additional contributions that, in case that it is not complied with, provokes a breach in the fulfilment of such arrangements or in the execution of the recovery plan.

Without having that previous commitment, the statement that the CCP's shareholders do not support the CCP's recovery action would not be appropriate. That support should have been previously materialised in a certain compromise that creates a right or an expectation.

The relevant paragraph could be drafted as follows:

"... are unwilling to recapitalise the CCP, ~~irrespective of whether~~ when there is a contractual commitment, parental guarantee, or similar arrangement to provide financial resources ~~or not~~."

The heading of point 1.2. (iv) could be drafted similarly to the scenario consisting of the CCP's clearing members not meeting their obligations under the CCP's recovery actions. (Points 1.1. (iii) and 1.2. (iii)):

"The CCP's shareholders do not meet their obligations under the CCP's recovery actions".

In this respect, ownership structure does not have to be considered for the assessment of financial resources for CCP resolution. In particular, in those cases where the CCP belongs to a group where other independent entities provide other critical financial services, CCP resolvability should be assessed in a standalone basis in order to avoid risk contagion.

Q2. Are there additional considerations that should be included in the guidance?

a) Combination of default and non-default scenarios

Even though the guidance refers (in the headings) to the identification of a combination of default and non-default scenarios, patterns or examples of how those combined scenarios could be presented and tackled are not provided for in the guidance, although they would be extremely useful.

b) Scenarios adapted to local circumstances

In addition, although the scenarios are presented as a minimum, we estimate that the resolution authorities should have the flexibility to consider resolution scenarios adapted to their local environment, CCP and jurisdiction and to contemplate additional ones not identified in the FSB's guidance.

c) CCP's financial resources

CCP's operators are relatively small companies compared to banks and other financial institutions. The position of CCP's is also different to the one of banks as CCP do not take or assume risks themselves but have to perform a proper risk management that reflects that entities that bring risk to the CCP contribute to cope with the risk within a mutualized system.

In this respect, CCP operator's resources are limited if compared to the risks brought by clearing members as it is supposed that those resources are not supposed to deal alone with those risks.

Of course, the CCP should have at any time the resources that are foreseen and required for regulatory purposes. In addition, there should be in place an adequate incentive for the CCP operator to perform an accurate risk management which is reflected by the part of the prefunded resources of the CCP that are designed and contributed by the CCP to cover the losses in the default waterfall before the recourse to the non-defaulting clearing members resources in order to ensure the adequate and optimal risk balance.

Beyond this, the idea of increasing the resources of the CCP over the legal and statutory limits should be carefully assessed as it may increase the cost of managing the CCP and would represent a burden on the CCP operator as well as unbalance the proper distribution of risks within the CCP.

Step 2: Evaluating existing resources and tools

Q3. Are the qualitative and quantitative considerations for evaluating existing resources and tools comprehensive and sufficiently clear?

The consultative document begins the considerations with a list of general key points applicable in every circumstance, followed by specific additional points for default loss scenarios and additional ones for non-default loss scenarios.

The qualitative and quantitative considerations for evaluating existing resources and tools are comprehensive and sufficiently clear.

In particular, the reference to the necessity for resolution authorities to take into account the implications arising from the specific types of products cleared and the potential impact on stakeholders incentives to support recovery or resolution, including clearing members, is specially welcomed.

Nevertheless, the CNMV Advisory Committee has the following comments:

a) Objectives and guiding principles

The points to evaluate the existing resources and tools are enumerated apparently without a specific order of priority so that they appear to have similar importance and there are no points in the list subordinated to others.

Even though, some points seem to affect the aim and objective of the resolution process itself, such as the ones that refer to maintaining continuity of critical functions and the need to avoid exposing taxpayers to loss.

We consider that those specific points should have the category of guiding principle and consequently, be highlighted before the other key points in order to give them a higher importance.

b) Recourse to CCP equity and other financial resources from the CCP or its affiliates

In the evaluation of the resources and tools by the resolution authorities, the CCP should be considered as an isolated entity, with no recourse to parent or affiliate entities' financial resources or guarantees, to avoid risk contagion. In this respect, the resolution authority assessment should be focused on the CCP itself, individually considered and its scope should not reach the parent companies or affiliates.

This consideration acquires special relevance in cases where other companies within the same group are FMI and provide critical services.

It could be accepted in cases where the recourse to a parent or affiliate had been expressly assumed by way of contract or another compromise.

We would suggest including such indication in paragraph 2.1.5. (ii), (for the default loss scenarios) as a complement to the reference to the availability of any additional resources beyond prefunded CCP equity dedicated to cover losses as part of the default waterfall.

And, the same comment applies to paragraph 2.2.2. (ii), (for the non-default loss scenarios).

c) Insurance coverage

The analysis to be made by the resolution authority on the availability and scope of coverage of insurance policies to cover non-default risks of the CCP, should take into account that insurance policies are difficult to obtain, due to the circumstances of the market in the last years. In addition, it is a voluntary element as it is not compulsory for the CCP to obtain an insurance policy of this kind.

d) Allocation of non-default losses to clearing members

Each stakeholder involved should bear non-default losses according to its respective level of responsibility, risk and/or benefits derived from the service. This includes CCP owner and CCP users (clearing members and others). But non-default losses should not automatically be allocated to the CCP.

This principle of responsibility of non-default losses between CCP and its participants should be mirrored in the resolution planning by authorities.

We welcome that this approach is expressly foreseen within point 2.2.3 of the consultative document when it refers to the contractual agreements for allocating non-default losses to clearing members.

e) Conversion of creditor claims into equity to recapitalize the CCP

Given that the CCP shareholders are subject to suitability requirements, that should prevail even in a resolution event, this objective could imply a potential different treatment over the creditors, based on suitability considerations, and not in mercantile ones, that may lead to a different treatment of creditors.

Q4. Are there additional considerations that should be included in the evaluation?

When referring to both default and non-default losses, there is a paragraph dedicated to the statutory powers of the resolution authority (2.1.6. and 2.2.5). This is an aspect of public policy that may have very relevant consequences in the resolution of the CCP.

The relationship and interaction between those statutory powers available to the resolution authorities and the CCP's rules as well as the NCWOL implications of the exercise of the statutory powers are of special interest.

We miss a more detailed explanation, within the guidance, of the relationship of the statutory public powers and the CCP's rules, the different scenarios that may arise depending on the different alignment between the CCP's rules and the resolution authority powers and the consequences for the evaluation.

Something similar happens with respect to the relationship between the statutory powers and the NCWOL consequences and implications. We find that a more specific and detailed information would be useful in the understanding and assessment of this matter.

Step 3. Assessing potential resolution costs

Q5. Are the considerations for analysing resolution costs comprehensive and sufficiently clear?

a) Default losses calculation

The consultative document states that costs to be assessed by the resolution authority include losses and costs that must be covered by the available resources.

Those resources are the ones specified in Step 2 and do not include the initial margins within the risk management process nor the resources that are available for the CCP recovery. Initial margins are (even at legal level in a good number of jurisdictions) exclusively aimed at covering the risk deriving from the cleared products and are not part of the own resources of the CCP available for resolution, regardless of the way of

posting them. They can only be used to cover the losses resulting from the closing-out of the position of the defaulting participants.

This means that losses to be considered are the ones that may remain after the recovery measures are applied by the CCP. More detail in the guidance for the calculation of the estimated losses that might have to be covered by the resources and tools would be appreciated. Mainly for default losses, as for non-default losses calculation the document states, at least, some criteria for its determination.

b) Administrative resolution costs

The consultative document includes within the resolution costs, the administrative cost of the resolution authority. While considering the cost of the CCP makes sense, as they have also to be paid by the CCP in normal conditions and, consequently, they have to be accounted for in the evaluation of the resources and tools, it is not explained nor clear why the costs of the resolution authority have to be paid using those resources considering that they are not covered by the CCP budget in a normal situation or even in the recovery process.

Those administrative costs could be limited to the extraordinary administrative costs borne by the resolution authority (as implicitly may be considered when last paragraph of Step 3 refers to management, legal or accounting costs) but not to all administrative costs, as the payroll of the employees of the authority or other current expenses might be.

Q6. Are there any other resolution costs that should be addressed?

NCWOL principle implies that resolution costs must be compared with liquidation costs to be able to assess NWCOL risks.

The FSB guide could also tackle which costs should be considered in a potential insolvency situation and how should they be estimated and calculated.

Step 4. Comparing existing resources and tools to resolution cost and identifying any gaps

Q7. What are your views on the considerations for resolution authorities when they identify gaps in resources and tools?

The exercise carried out by the resolution authority should not be the same as the one carried out by the CCP in the risk and default management processes and in the recovery stage. There are differences both in the part of the resources and tools available as well as in the resolution costs.

The assessment by the resolution authority should be based on a different exercise that has different elements than the ones of the CCP for the initial margins and recovery plans.

In this regard, resolution authority should not consider or count on the recovery tools. Any additional tools to be considered in resolution should be different to the ones reserved to recovery and should be subject to an independent assessment by the resolution authority.

Q8. Are there additional considerations that should be included in the guidance?

The resolution authority should give enough time to the recovery plan deployment and execution until the complete depletion of the resources and tools foreseen in the recovery plan and the CCP's rulebook.

Even though the resolution authority may fear that a late intervention may reduce the effectiveness of the resolution, the resolution plan is supposed to have been designed considering the risk management and the recovery plan by the CCP and to ensure that the resolution plan does not affect the potential successful recovery by the CCP.

In case that the resolution authority steps in before the exhaustion of the CCP's recovery plan, it should be convinced about the need of its intervention based on financial stability considerations and even been able to prove and demonstrate it with enough evidence.

Q9. Are there any specific steps or approaches you would suggest that authorities consider as part of quantitative analyses?

As already mentioned and included within step 2 of the guidance, the resolution authority should consider the implications arising from the specific types of products cleared. Specially from those that could represent more risks to the CCP.

Step 5. Evaluating the availability, costs and benefits of potential means of addressing any identified gaps

Q10. What are your views on the consideration for evaluating the availability, costs and benefits of potential means to address identified credit or liquidity gaps?

The CNMV Advisory Committee agrees with the points outlined in the consultation document to be considered including the ones that have to do with the potential implications of requiring any additional resources or tools.

A special remark could be done to the implication of additional financial resource requirements on the cost and expenses of central clearing and the negative effect of making it less attractive.

Q11. Are there additional suggestions for potential steps to address identified credit or liquidity gaps that should be included in the guidance?

It should be tackled how and when could resolution take place if the regulatory capital of the CCP was reduced under the minimum due to the exercise of resolution powers. It would challenge the whole resolution process and the resolution objective of maintaining continuity of the critical functions as it would represent a breach of the authorisation conditions and the license and operation of the CCP would be at risk.

PART II. TREATMENT OF CCP EQUITY IN RESOLUTION

Q12. Are the considerations for addressing the treatment of CCP equity in resolution plans sufficiently clear?

Yes, in the opinion of the CNMV Advisory Committee, the considerations for addressing the treatment of CCP equity in resolution plans are sufficiently clear.

With regard to the implications for the application of the No Creditor Worse Off in Liquidation (NCWOL) safeguard, we believe that it is key to clarify the counterfactual concept, so that resolution authorities are not constrained in the use of resolution tools by possible claims invoking this principle.

It is necessary to bear in mind that the value of the continuity of the CCP clearing services is very high for Clearing Members, and as such, it should be taken into account in relation to the counterfactual. For the CCPs shareholders, who would lose everything in the event of liquidation of the CCP, there is no case for claiming against the Resolution Authority. This remark in the NCWOL counterfactual would limit possible ex-post claims against Resolution Authorities.

The CNMV Advisory Committee would also like to insist that legal certainty is essential and therefore bankruptcy and insolvency national laws must be perfectly aligned with the regime of CCPs resolution, as pointed out in section 6.

Q13. Are there additional factors that resolution authorities should consider when evaluating the exposure of CCP equity to losses in resolution?

We believe that the factors considered are adequate to evaluate the exposure of CCP equity to losses in resolution.

Q14. Are there additional mechanisms that could be used for adjusting the exposure of CCP equity to losses in resolution that should be included in the guidance?

It is foreseen within the mechanisms for adjusting the treatment of CCP equity in resolution the possibility of compensating clearing members by providing shares in the CCP in return for any cash call or VMGH that is applied beyond the arrangements set out in the CCP's rules.

We find that such scheme breaks the CCP's incentive structure and therefore reduces the resilience of CCP's. CCPs have an incentive structure which ensures that all clearing participants are committed to contribute to the continuity of the CCP avoiding

resolution. Any type of compensation in the resolution phase would harm such incentive scheme: the fact that clearing participants might have the opportunity to be compensated during resolution could prevent them from participating in the regular default waterfall process or in the use of the recovery tools contained in the CCP Recovery Plan.

If compensation is established as a resolution tool, clearing members would not have an impact on their resources beyond the default waterfall. Their responsibility for the contribution would be limited to the effective amount foreseen in the CCP's rules. Any amount in excess of that contribution, would then be subject to compensation. This represents that it would have the same effect as a loan made to the CCP.

This would have the effect of reducing the resolution tools available for the resolution authority.

It would also represent a disincentive for operating a CCP. As risk managers with limited resources, CCP's would be obliged to compensate clearing members for mutualized losses as if they were just lenders. That circumstance would represent, at the end, a dilution of the CCP's stake.

In addition, it would mean an incentive for clearing members to push for a reduction of the amount of their contribution under the CCP rulebook in order to lower the amount that the clearing member could lose and, in parallel, increase the possibility of being compensated for the amount in excess of its contribution. CCPs have to set up an incentive structure which commits clearing participants to contribute and take part in the default waterfall process and in the recovery plans of the CCP for the sake of the continuity of the CCP avoiding resolution. Any type of compensation in the resolution phase would interfere in the incentive scheme.

Finally, it could give rise to claims against the resolution authority as that compensation provides clearing members with a new way for compensation without the limits of the NCWOL. Any deviation by the resolution authority from the CCP's rulebook could give rise to claims.

Q15. Within the section on implementing policy for the treatment of CCP equity in resolution, are there additional items that the relevant home authorities should consider?

The CNMV Advisory Committee finds adequate the items that the relevant home authorities should consider for the treatment of CCP equity in resolution.

Specifically, the relevant home authorities should evaluate and justify whether an adjustment to ensure equity fully bears losses in resolution would be appropriate considering the impact on CCP management incentives, on stakeholders incentives to support recovery and avoid resolution, impact on clients, impact on continuity of critical services and on different business models and legal structures of CCPs.

Q16. Would a statement in the resolvability assessment process on any limitations to equity bearing losses provide sufficient transparency for stakeholders? How could sufficient transparency be achieved?

Yes. It could be achieved by a statement on any limitation to equity bearing losses. In addition, it should be clearly stated within the resolution plan made by the resolution authority.