

clear to trade



**Eurex Clearing  
Response  
to the**

**FSB Consultative document  
on**

“Guidance on financial resources to support  
CCP resolution and on the treatment of CCP  
equity in resolution”

July 2020

## A. Introduction

Eurex Clearing is a globally leading, EMIR authorized central counterparty clearinghouse (CCP). Eurex Clearing is a subsidiary of Deutsche Börse Group providing central clearing services for cash and derivatives markets both for listed as well as certain over-the-counter (OTC) financial instruments. Eurex Clearing actively contributes to market safety and integrity with state-of-the-art market infrastructure as well as with industry leading risk management services for the derivatives industry. Eurex Clearing is also licensed as a credit institution under supervision of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) pursuant to the Banking Act (Kreditwesengesetz). US Commodity Futures Trading Commission has (CFTC) granted Eurex Clearing Registration as a Derivatives Clearing Organization.

Eurex Clearing appreciates the FSB’s ongoing work it and other international standard setting bodies continue on key financial stability and market integrity topics. In general, we consider that the FSB Key Attributes and CPMI-IOSCO PFMI, and the specifications for CCPs in the FMI Annex and the corresponding CPMI-IOSCO recovery report, and their jurisdictional implementation in our case, have suitably structured the risk management and incentive structure of centrally cleared markets.

In this context, we welcome the opportunity to provide feedback to the FSB consultative document “Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution”. We have also responded to previous FSB consultations, including the 2018 “Financial resources to support CCP resolution and the treatment of CCP equity in resolution”.

In line with our previous response to the FSB consultative document from 2018, we appreciate and agree with Part I – Financial resources for CCP resolution of the FSB guidance. In particular, we welcome the FSB’s considerations of the impact of any measures on the incentive structure of the CCP system as a whole, the incentive to clear and the cost of clearing. However, we would like to share some thoughts for consideration. Resolution authorities should have some form of flexibility in handling resolution scenarios which might not be covered in the plan. Resolution scenarios can be more extreme than recovery scenarios, however they should remain plausible. In this context, it appears important to emphasize the importance of flexibility in the application and possible combination of the listed resolution tools. A flexible approach will ensure the best possible reaction to a given situation in the interest of financial stability.

With regard to Part II – Treatment of CCP equity in resolution, we would like to highlight that the resolution authority should have sufficient flexibility to act appropriately in resolution without fearing undue claims by the CCP shareholders or its clearing members. In our view, recent discussions in some parts of the industry have, purposefully, conflated the issue of CCP equity shareholders bearing losses with the question of using CCP resources or public sector funds to cover clearing members’ losses or potentially "compensating" them. However, the conceptual framework created and established by the FSB work on resolution clarified the restrictions and protections on claims from creditors towards the resolution authorities through its No Creditor Worse off than in Liquidation (NCWOL) principle. As such, it is key for the NCWOL-principle and in particular the counterfactual to be well designed in order to effectively fulfil its purpose and to limit compensation claims only to situations where the outcome of the resolution strategy is worse than under the NCWOL counterfactual. Compensation for other motives effectively unnecessarily exposes the public purse (when the resolution authority takes over the CCP) and skews the incentive structure of the CCP, as members may seek to shorten the CCP rulebook in order to limit the ‘sunken costs’ of recovery before getting compensation.

In line with this, we believe a clarification of the NCWOL counterfactual is necessary to limit compensation to NCWOL cases, which reflect the real economic costs of closing a CCP. Such a clarification would be consistent with the Key Attributes, the FMI Annex, and existing practice in many jurisdictions' recovery and resolution planning.

Regarding the treatment of CCP equity in liquidation, it is important to assess what would have happened had the CCP been liquidated under the applicable insolvency law. It is our understanding that in most jurisdictions, like the EU, the CCP shareholders' equity would be fully exposed to losses in insolvency. Hence, based on the clarification of the NCWOL counterfactual, there is no NCWOL claim from the CCP's shareholders, because the CCP shareholders lose everything in insolvency/liquidation. However, it can be the case that resolution authorities intend to keep working capital of a CCP under resolution separate from the default management waterfall. In such cases, we see no tension in exposure of CCP equity since the intention in the Key Attributes and successive work has simply been to ensure that previous, private shareholders are appropriately affected by resolution.

Such clarifications could also be beneficial for claims from clearing members. As per the recently agreed EU framework on CCP Recovery & Resolution, the NCWOL counterfactual should take into account the hypothetical costs of closing down a CCP for members, such as the cost of losing one's positions and having to replace them.

Furthermore, and most importantly in reaction to footnote 26, we do not believe that clearing members need a further, new, incentive to participate in resolution. Given the costs that clearing members would have incurred under a CCP liquidation, any resolution action until the point of NCWOL is a better economic outcome and therefore preferable. Therefore, the FSB should clarify the negative consequences of issuing compensation in resolution, notably when the resolution authority wipes out the CCP's equity, and instead recommend compensation to be limited to NCWOL cases, where the execution of the resolution strategy leads to a worse situation than normal insolvency proceedings would have.

## B. On Specific questions raised

### 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?

- We appreciate the distinction between default and non-default events and we agree with all of the depicted scenarios.
- However, we would like to highlight one aspect for consideration regarding scenario 1.1 i). From an EU perspective, this scenario appears rather unlikely as EU CCPs are closely supervised to fulfil EMIR requirements as well as CPMI-IOSCO standards.

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

- We believe that the listed scenarios should not be considered as an exhaustive list, as resolution authorities should have some form of flexibility in handling those resolution scenarios which might not be covered in the plan.
- Furthermore, one could also consider a scenario in which multiple of the listed events/scenarios materialise concurrently.

- Recovery planning scenarios should be extreme but plausible. Although the general consensus is that resolution follows an unsuccessful recovery phase, this does not mean that the resolution scenarios should be (far) more extreme to start with – a recovery scenario in which the recovery to viability fails could also be a reasonable resolution scenario. Resolution scenarios should not be implausible.

## Step 2: Evaluating existing resources and tools

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

- We believe the listed considerations include the most important points for the evaluation of resolution tools. We consider the impact of a tool on the incentive structure as most important.
- From our perspective, the list of most important resources and tools contains the most relevant ones. In this context, it appears important to emphasize the importance of flexibility in the application and possible combination of the listed tools. A flexible approach will ensure the best possible reaction to a given situation in the interest of financial stability.
- The original Key Attributes are quite clear that No Creditor Worse Off than in Liquidation (NCWOL) does not imply *pari passu*. While we agree that an unjustified or unequal allocation of losses may well be contested, and that NCWOL does distinguish creditor classes, we believe and observe that to increase likelihood of a successful default management process, CCPs should have properly balanced incentives, like mandatory participation in auctions, fines or juniorization of the default fund contribution for non-bidding mandatory auction participants in place. This incentive scheme should be fair, and in place to increase positive behavior and minimize the probably of game theoretic pressures, especially given the possibility for collective-action problems or free-rider effects to arise.

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

- We like to point out that not all derivatives have a symmetric variation margin prior to conclusion of the trade, and hence, not all CCPs have elected to use variation margin gains haircutting (VMGH) in recovery.
- We would mention that “buy-in” can be used as the terminology for certain types or matched book tools.

## Step 3: Assessing resolution costs

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

- We agree with the outlined wide approach to defining resolution costs, and that the listed points are suitable to estimating the costs of resolution.
- For estimating operational risk costs, one could take the CCP's Business Continuity Management plans into account. These plans, in general, take into account potential replacement costs of operational assets (e.g. property or servers) in time of crisis.

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

- The key concern for authorities, and the market generally, is to have an evaluation of the possible costs of a wind-down and liquidation/insolvency, so as to be able to estimate if NCWOL is relevant.
- This requires considering consequences which market participants, as well as the CCP operator, would suffer if following recovery and wind-down tools, the CCP was closed down through insolvency.
- Please see our more detailed answer to Q12.

Step 4: Identifying gaps

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

- We welcome the considerations for identified gaps in resources and tools available as well as the link to recovery, as the recovery phase could significantly impact the available financial resources.

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

- We would highlight that resolution does not avoid losses but is rather the question of how to minimize or direct the impact of failure and allocate losses. We mention the point as some of the phrasing of the consultation implies a sequence of additional layers of safety is considered. In particular, we do not consider it necessary or sensible to assume that all tools will fail, and that alternatives for them must be available. If we for instance compare to bank resolution work, there are no ongoing consultations on what-if TLAC fails or is insufficient.

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

- In order to quantify potential gaps, a good starting point would be the recovery scenarios. These scenarios should display the dynamics of the CCP and its sensitivity to different types of losses (e.g. default vs non-default losses).

Step 5: Evaluating means to address gaps

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

- We particularly appreciate the considerations of the impact of any measures on the incentive structure of the CCP system as a whole, potential disincentive to clear and the cost of clearing.
- We believe that carving out prefunded resources for resolution will not prove ideal for all scenarios – e.g. where the extra resources could reestablish a matched book in recovery without having to trigger resolution, it appears more logical to use the extra funds in the recovery phase.
- We strongly oppose to introduce the option of what is termed a bail-in power in this consultation as it breaks the loss mutualisation principle the CCP is based on, shifts the cost of covering tail risks solely to the operator and as such creates an inequitable loss distribution. The introduction of bail-in would significantly impair the incentive structure of the CCP, which is fundamentally one of loss mutualization across market participants. CCPs are not banks, nor insurance companies, and do not borrow or deploy their own money to underwrite and take on risk. However, as part of this participant-collateralized model, a CCP operator should accept that for default losses, the CCP is lose-only (SITG and other default waterfall resources) and lose-all (resolution authority take-over or insolvency). This is an extremely strong incentive structure for the operator. Thus, we do not consider that the introduction of bail-in is necessary, nor that there is an issue with CCP operator incentives to be rectified in such a configuration.
- Finally, we would reiterate our comment from previous consultations that to the extent that certain cleared contracts have theoretically unlimited pay-offs, then a market that insists on limited cash calls must, in a "comprehensive" loss allocation structure ultimately either modify these economics (e.g. VMGH), or terminate the positions (e.g. PTU).

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

- No comment.

## Part II - Treatment of CCP equity in resolution

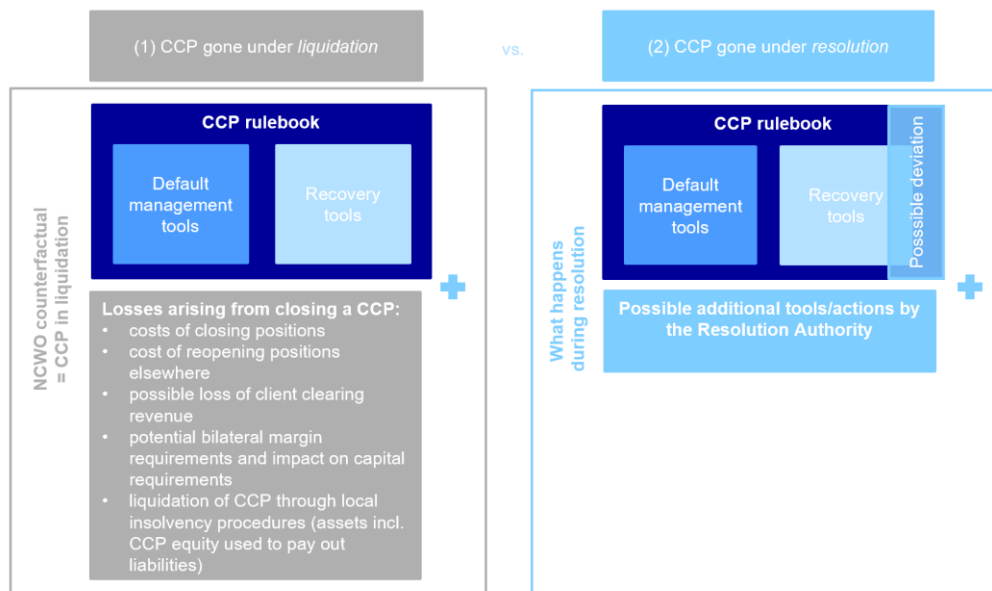
Q12. Are the considerations for addressing the treatment of CCP equity in resolution plans sufficiently clear?

- We welcome the efforts of the FSB to provide further guidance on the treatment of CCP equity and would like to reiterate that a CCP entering into resolution should be linked to writing down its equity. This considers the fairness perspective but also creates the right incentives for the CCP beforehand.
- While we agree with most of the FSB's guidance, we believe that recent discussions in some parts of the industry have, purposefully, conflated the issue of CCP equity shareholders bearing losses with the question of using CCP resources to cover clearing members' losses or potentially "compensating" them. This distinction becomes apparent

if one probes the interlocuters in question whether having ensured that CCP equity is loss bearing in resolution is sufficient.

- We believe that some of the confusion may rise from the original work on banking resolution. In a bank resolution scenario, the Key Attributes are clear that resolution authority has the power to write-down debt owed by a bank to creditors or to convert it into equity for recapitalization. The approach to haircut liabilities was rightly driven by the expected inability to raise the asset side of the balance sheet.
- However, CCPs do not issue debt and are not leveraged, and thus simply do not have creditors which would have a claim or a right on the CCP or future profits. CCP resolution seeks to re-establish a matched book resolving any unbalance created by a member default by using position or loss allocation tools. Therefore, analogous mechanisms to bank resolution such as bail-in requirements or creditor claims are not appropriate in the context of CCP resolution.
- It must also be borne in mind that the new conceptual framework created and established by the FSB work on resolution clarified the restrictions and protections on claims from creditors towards the resolution authorities through its NCWOL construct. This outlines that resolution must, per creditor, not be inferior to insolvency, but also that creditors cannot expect "compensation" from resolution proceedings if they have fared better than could have been the case in insolvency.
- In this context, **we believe a clarification of the NCWOL counterfactual is necessary** to limit scenarios whereby "actions in resolution that expose CCP equity to larger default or non-default losses than in liquidation under the applicable insolvency regime could, based on the relevant counterfactual, enable equity holders to raise NCWOL claims." This clarification is in our view consistent with and the implied intention of the Key Attributes, the FMI Annex, and existing practice in many jurisdictions' recovery and resolution planning.
- The NCWOL safeguard should not be used as a means to tie the hands of Resolution Authorities which could be exposed to ex-post financial claims, or to make the resolution mechanism of CCPs prone to the moral hazard. Both the CCP shareholders, but crucially its membership, should not come to expect or rely on public support to replace their potential losses. A sound and prudently managed CCP ecosystem requires and benefits from participants' willingness to entail the costs of rigorous risk management, in order to avoid sudden or dramatic costs of disruption or failure. If the public sector or Resolution Authorities indicate a great willingness to cover losses through "compensation", it will naturally lead to a reluctance to bear with costly risk management. This is in particular poignant if Authorities consider that any losses "above and beyond" what participants themselves agree to as the desired level of safety is the bar beyond which "compensation" is offered.
- As such, it is key for the NCWOL-principle and in particular the counterfactual to be well designed in order to effectively fulfil its purpose. The FSB 2017 Guidance notably states that in accordance with the Key Attributes principle in the FMI Annex "*for the purposes of determining whether a participant, equity holder or creditor is worse off as a result of resolution measures than in liquidation of the CCP under applicable insolvency law, **the assessment of the losses that would have been incurred or the recoveries that would have been made if the CCP had been subject to liquidation** should assume the full application of the CCP's rules and arrangements for loss allocation.*"
- The NCWOL can therefore be understood as a comparison between:

- a **hypothetical scenario where the CCP would have gone under insolvency/liquidation**, and
- the **practical outcome after the intervention from the resolution authority**.



- In other words, under scenario (1) in insolvency/liquidation, the resolution authority decides not to take any action, the CCP applies its rulebook entirely and the CCP is liquidated under the applicable insolvency law. Scenario (1) would then be compared with scenario (2) in resolution, where the resolution authority intervenes, puts the CCP under resolution. For proper incentives management, we would expect the resolution authority to write down the shareholders under scenario (2), or employ existing CCP resources to cover ongoing costs or other suitable measures.
- However, as part of “*the assessment of the losses that would have been incurred or the recoveries that would have been made if the CCP had been subject to liquidation*” under scenario (1), the **FSB guidance should clarify that these losses go well beyond those incurred by the full application of CCP’s rules and loss allocation arrangements**. The fact that the later should be included in NCWOL counterfactual does not imply that these should be the only ones considered (i.e. they are necessary but not sufficient). Otherwise, the NCWOL counterfactual may be misunderstood as a comparison between recovery (the CCP rulebook) and resolution. We would highlight that this is not only the logical reading, but also our ongoing experience of discussions within the FSB framework.
- Regarding the treatment of CCP equity in liquidation, **it is therefore important to assess what would have happened had the CCP been liquidated under the applicable insolvency law**. It is our understanding that in most jurisdictions the **CCP shareholders’ equity would be fully exposed to losses**. Due to the close-down of the relevant clearing service, the CCP shares would no longer have any economic value and the remaining capital of the CCP would be liquidated to pay off outstanding debts.
- Note that, because the NCWOL compares two quanta, the fact that the exposure of the CCP shareholders comes after the full application of the CCP rulebook in time does not matter. If, however, Authorities consider that one or the other CCP has a rulebook that, in conjunction with existing law, makes it less clear or if there is a degree of protection that is considered inappropriate or undesirable, we would expect that this can be easily clarified in the resolvability assessment or in the course of normal supervision.



- Based on this clarification of the NCWOL, because the CCP shareholders lose everything in insolvency/liquidation, there is no NCWOL claim from the CCP’s shareholders. The CCP is in effect a lose only machine.

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

- As per section 6, if it remains unclear in a specific jurisdiction whether the CCP’s equity is indeed fully exposed in insolvency/liquidation, the **FSB’s guidance should clarify that the relevant home authorities should consider fixing the problem in insolvency/liquidation**, by either:
  - Clarifying the applicable insolvency law; or
  - Requiring the CCP to liquidate its remaining equity at the very end of its rulebook.
- We would highlight that it is conceivable that certain jurisdictions have for local regulatory or legal reasons elected to retain a certain form of protection of the equity (or conversely, to expose it differently). This may, for instance, be the case of jurisdictions in which the CCP is a partially or fully public entity. As such, we would note that the above recipe can in our view be deployed where needed but would not suggest that it must be applied universally. Other measures on the resolution end of the NCWOL spectrum in sections 7 and 8, such as additional use of CCP equity or compensation of clearing members would not solve the NCWOL issue at hand and are therefore inherently misleading.

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?

- Compensation of clearing members through the issuance of new shares in exchange for them bearing more losses in resolution would not solve the issue of potential NCWOL claims from CCP shareholders. Because NCWOL claims only arise if a participation is worse off in resolution (2) than in liquidation (1), adding more ways of using CCP equity in resolution (2) just makes the problem worse. As explained in our response to Q. 12 and 13, the issue needs to be solved in liquidation (1).
- Otherwise, **providing compensation beyond the CCP rulebook could prove extremely dangerous**, notably in situations where the Resolution Authority (RA) takes over the CCP and wipes out the CCP’s equity, as it:
- **Creates clearing member claims on the RA** – because the CCP is now under the control of the RA, compensation of clearing member would effectively create a claim on the RA and severely limit the actions of the RA in resolution. If these claims are not directed at the RA, then they could only be directed at the empty shell of the discontinued legal entity of the former CCP.
- **Weakens the incentive structure** – if clearing members know beforehand that, as from the point of resolution, they are essentially reimbursed for their losses, they will naturally seek to weaken the CCP rulebook in order to diminish the ‘sunken costs’ of the recovery tools, thereby fragilizing the CCP and weakening recovery.
- **Is fundamentally unfair** – the RA would have to pay out claims to clearing members for having improved their individual welfare situation compared to the costs they would have faced had the CCP gone under insolvency/liquidation procedures (i.e. full tear-up).

- **Exposes public money and reintroduces moral hazard.** Based on various advocacy papers, we also highlight the concern a presumed "compensation" based on claims outside of the NCWOL process and the inability of the RA to write these down.
- Most importantly in reaction to footnote 26, **we do not believe that clearing members need a further, new, incentive to participate in resolution.** Given the costs that clearing members would have incurred under a CCP liquidation, any resolution action until the point of NCWOL is a better economic outcome and therefore preferable. Moreover, it is commonly accepted that, should a clearing member fail or refuse to participate in a loss allocation tool, the clearing member would be put in default, losing access to the CCP and passing on its initial margin to the CCP (which would be multiples above the cost of most resolution actions)
- In this context, in order to ensure an appropriate incentive structure, the **FSB should clarify the negative consequences of issuing compensation in resolution**, notably when the resolution authority wipes out the CCP's equity, and **instead recommend compensation to be limited to NCWOL cases**, where the execution of the resolution strategy leads to a worse situation than normal insolvency proceedings would have.
- This has also been reflected in the recently agreed European CCP RR framework which stipulates that compensation cannot happen for agreed recovery tools and limits compensation in resolution to cases where clearing members are worse off than in insolvency, taking into account the costs of insolvency which include the costs of replacing cancelled contracts for defining the NCWOL counterfactual.

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?

- As part of section 8, we agree with the FSB's guidance and would like to add three additional **principles for CCP equity shareholders bearing losses**:
  1. **Fairness** – CCP shareholders should bear losses in all scenarios where the CCP has failed, both in insolvency/liquidation and in resolution;
  2. **Protection of the resolution authority** – The resolution authority should have sufficient flexibility to act appropriately in resolution without fearing successful claims by the CCP shareholders or clearing members;
  3. **Preservation of the CCP incentive structure** – The process of CCP equity shareholders bearing losses or clearing members covering losses in resolution should not weaken the incentive structure of the CCP. The incentive structure of the CCP is key to avoid insolvency or resolution in the first place.

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?

- We consider that this is broadly captured by existing practice, and indeed are in regular discussion with market participants that form their view of both a CCP's strength as well as create their own evaluations on worst-case scenarios that capture the degree to which member and non-member resources are available. However, there is no harm that regulators insist that, to the degree this process is defective, CCPs are able to communicate relevant figures on their resources to their participants. Naturally, we would not expect that regulators are unaware of the available resources to them.

## C. Closing remarks

We hope that you have found these comments useful and remain at your disposal for further discussion. If you have any questions, please do not hesitate to contact:

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