Response to the FSB/CPMI/IOSCO Consultation Paper
"Central Counterparty Financial Resources for Recovery and Resolution"

MANAGEMENT SUMMARY

The International Swaps and Derivatives Association (ISDA), The Futures Industry Association (FIA) and the Institute of International Finance (IIF), collectively the Associations, represent the largest number of participants in national and global clearing, banking and financial markets. The Associations appreciate the opportunity to comment on the consultation paper "Central Counterparty Financial Resources for Recovery and Resolution" [1] (the consultation paper).

This response covers the positions of our members on the buy-side and sell-side. The paper does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views.

We would also like to refer to our responses to FSB's 2020 consultation "Guidance on Financial Resources to Support CCP Resolution and on the Treatment of CCP Equity in Resolution"[2] and FSB's discussion paper "Financial resources to support CCP resolution and the treatment of CCP equity in resolution"[3], which was published in November 2018. The comments submitted by the Associations in response to the 2020 consultation and the 2018 discussion paper are still valid and form the basis for this response. We also refer to our analysis of recovery and resolution tools in our paper "Recovery and resolution: Incentives Analysis"[4], which covers many of the same tools assessed as part of the FSB's qualitative analysis of recovery tools in this consultation paper, even though we come to different conclusions for certain tools.

We welcome the FSB's ongoing focus on the important topic of adequacy and impact of CCP financial resources for recovery and resolution. CCPs are a cornerstone of the financial system and their resilience, recoverability and resolvability are paramount to preserve financial stability. We welcome the initial analysis presented in the report, and support the FSB's proposed next steps, including widening the analysis to cover a broader set of entities and reviewing the cost and benefits of alternative financial resources and tools for CCP resolution. In this response we offer our views on the FSB's analysis and make suggestions to enhance future analyses and related work on this important topic.

- While we welcome the consultation paper's finding that CCPs that were part of the analysis were resilient overall, the reliance on recovery tools – such as cash calls at eight CCPs,

[1] https://www.fsb.org/wp-content/uploads/P090322.pdf
[2] https://www.fsb.org/wp-content/uploads/P161120-1.pdf, response https://www.isda.org/2020/07/31/fia-iif-and-isda-respond-to-fsbs-consultation-on-ccp-resources-in-resolution/
[3] https://www.fsb.org/wp-content/uploads/P151118-2.pdf, response https://www.isda.org/a/YrgME/FIA%E2%80%90IIF%E2%80%90ISDA%E2%80%90response%E2%80%90to%E2%80%90FSB%E2%80%90CCP%E2%80%90Equity%E2%80%90DP.pdf
[4] https://www.isda.org/2019/03/15/ccp-recovery-and-resolution-incentives-analysis/

extending into variation margin gains haircutting (VMGH) at two of them under the default loss scenario – suggests a need to review sufficiency of defaulters' resources and the adequacy of CCP capital to ensure risk management incentives are appropriately aligned.

- CCPs were also resilient under the liquidity non-default loss scenario. However, we are concerned about the finding that the majority of CCPs required resolution in the cyber theft scenario.
- As part of the qualitative analysis of recovery and resolution tools we would have welcomed the assessment of tools against a "fairness" criterion and also the consideration of CCP equity, pre-positioned resolution resources, compensation to market participants, and a discussion of recapitalization.
- Overall, the consultation paper focusses disproportionately on loss allocation tools to clearing participants and does not emphasize sufficiently the role of CCPs' own financial resources. We believe that a better balance between loss allocation to clearing participants and loss allocation to CCPs would promote better outcomes from a resilience and financial stability perspective.

CONSULTATION RESPONSE

<u>Loss Analysis</u>

We welcome the loss analysis in form of an extreme stress test for CCPs systemically important in more than one jurisdiction (SI>1). While we appreciate the efforts to collect and aggregate this data, we hope that the SI>1 CCPs that were not part of this analysis could be added in due course. Also, other important CCPs that are systemically important in only one, but major jurisdiction, could be included in future.

Default Losses

On paper the loss assumptions used in the FSB's analysis (four clearing members defaulting under a stress 1.4 times more extreme than the historical worst stress) look very extreme. However, recent events in the commodity and energy markets, including unprecedented price moves which were in some cases more than three times historical price moves, suggests that shocks could be more extreme than in historical events. We propose to also use hypothetical scenarios of CCPs to size shocks in future exercises considering the CCPs include them in their stress testing suite because they believe them to be relevant and within the realms of extreme but plausible.

We welcome the finding that half the CCPs in the sample could cover the losses with their prefunded resources, i.e., the defaulters' resources and non-defaulters' default fund (DF) contribution. However, given that eight of the CCPs had to rely on recovery cash calls and two CCPs had to use VMGH – one to a very limited extent, another quite significantly – we believe there is merit in undertaking additional work related to resources to address default losses. We appreciate that there are confidentiality issues, but hope these CCPs' regulators will carefully analyze why these CCPs had to resort to such invasive measures for the whole market, which themselves could raise financial stability concerns. We propose for the CCPs in the study that had to resort to cash calls and to VMGH to review their margin models, especially the CCP that has to use a significant amount of cash calls and/or a large part of the VMGH capacity.

We welcome the data provided by the consultation paper that shared as much information as possible under the confidentiality constraints. It would further help market participants to understand and analyze the results were recovery tools and resolution tools separated out rather than combined under the same heading "second tranche".

The report states that "*The defaulters' core initial margin available to cover losses covered 32% to 89% of total stress losses*". We wonder whether the fact that Initial margin (IM), which is meant to cover risk with a 99% confidence interval, only covered 32% of stress losses raises questions about whether IM models were conservative enough for some CCPs.

We also note that the usage of funded DF contributions ("*The non-defaulters' default fund contributions that were used ranged from $5.3m to $6.3b*") was very sizeable.

We agree with the challenges that the report outlines and believe that there should be further work undertaken by regulators and policymakers, not only for non-default losses but also for default losses, especially since the consultation paper acknowledges that the results should be interpreted cautiously, for instance because:

- The analysis of financial stability implications of use of recovery tools was limited to bank clearing members subject to strong liquidity requirements while the majority of CCP clearing members are non-bank institutions.
- The analysis does not consider impact of use of recovery tools like VMGH on end-users who may be more resource and liquidity constrained than clearing members.
- Considering the analysis was restricted to a subset of bank clearing members, the observation that "*some clearing members did breach their regulatory minimum LCRs under the more extreme liquidity stress scenarios*" raises cause for concern.
- The consultation paper did not take into account potential contagion, amplifying effects and interconnectedness across CCPs and in the broader financial system.
- The analysis assumes that non-defaulters will perform whereas in reality, there will likely be rating migrations and inability to pay.
- In a real stress event, there would be competing demands on clearing participants' resources.

Non-default Losses (NDL) – Liquidity risk

We note that CCPs could overall withstand the extreme scenarios with complicating assumptions.

We are concerned, however, by the fact that the loss of access to the institution (as defined in the consultation paper) that would have caused the largest liquidity shock for one CCP "*would also have had significant operational consequences for the settlement..*". It is very important for CCPs and their supervisors to consider what contingency plans a CCP has in place for such circumstances.

While it is positive that all CCPs in the sample had sufficient liquidity resources available to withstand the assumed shock, it is unclear whether this sample included all large CCPs that clear repos and therefore have very high liquidity requirements.

We also do not think that rulebook provisions that merely pass the liquidity shock to clearing participants (both clearing members and their clients) constitute a reliable or reasonable solution. Fortunately, none of the CCPs had to resort to these rules in this test.

Non-default Losses (NDL) – Cyber theft

While we appreciate that CCPs are required to implement strong cyber defenses, cash stolen as in scenario 2 is a possible scenario. We are concerned about the result of this stress test: five out of seven CCPs had to utilize resolution resources, which might well have included the write down of liabilities, i.e. allocation of the losses to clearing participants. We believe that in this case the resolution authority (RA) should utilize right-sized CCP equity before writing down liabilities to clearing participants, which would also create the right incentives for the CCP to have strong cyber defenses ex-ante. After all, clearing participants do not have any influence or full visibility about the cyber risk or cyber resilience of the CCP.

For the reasons mentioned above (i.e., clearing participants' lack of influence over management of these cyber-related risks), we do not believe that simply transferring non-default losses to clearing members is an appropriate solution. We would also be interested what the business as usual (BAU) and recovery resources consisted of that allowed two CCPs not to enter resolution and whether there are lessons-learned that could be more widely applicable from these two CCPs. In terms of available resources, we would welcome the use of insurance to cover for such losses, as opposed to tools that merely pass losses to members, either directly or via cash calls. We believe that the better approach would be to utilize insurance, right-sized equity and potentially prefunded resolution resources.

Financial stability implications

Quantitative impact on clearing members

Given the recent BCBS-CPMI-IOSCO consultative report "Review of margining practices"[5] which identified liquidity issues with non-bank financial institutions, widening the analysis to non-bank clearing members and clearing participants in general would create a more complete picture of the risk posed to the system. Only considering bank clearing members might provide a false sense of security, given that such entities are subject to robust capital and liquidity requirements.

We welcome the finding that the potential use of resolution tools, such as cash calls and VMGH, appears to have a notably less significant impact on clearing members' liquidity in comparison to their starting liquidity positions. However, we urge standard setters not to determine that clearing members should therefore always be the preferred options for loss absorbance, just because they are able to do so. Over-reliance on clearing members raises significant moral hazard and fairness concerns.

Qualitative review

We refer to our analysis of recovery and resolution tools in our paper "Recovery and resolution: Incentives Analysis", which overlaps significantly with the qualitative analysis of recovery tools in this consultation paper, even though we come to different conclusions for several tools.

While we welcome the analysis, we believe that the consultation paper does not capture an important factor: fairness – meaning whether it is appropriate for one group of stakeholders to

[5] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD686.pdf

cover losses (potentially without compensation) which were the result of factors outside of their control, or losses predominantly being allocated to one group of stakeholders. Also, while the analysis considers ”incentivization”, there is little mention of the negative incentives for CCP shareholders if CCPs can allocate most losses to other stakeholders and at most lose their skin-in-the-game (SITG), which for many CCPs is a resource which is de minimis compared to resources provided by clearing participants. This structure creates moral hazard concerns which could be captured in future work on this topic by the FSB.

The analysis would benefit from considering the use of CCP equity in resolution, compensation of clearing members for losses and pre-funded or pre-positioned resolution resources. Including these factors would provide a more holistic view of the impact of recovery and resolution tools.

Please find below some comments to the tools analyzed in the consultation paper and other resources that should be included in futures analyses.

Cash calls

Cash calls as a resource in recovery and resolution are used across many CCPs and form part of the “classic” waterfall. We however do not agree that there is a low performance risk. The performance risk is low for a low number of cash calls across recovery and resolution, but increases when more cash calls are made. We note that in the default loss scenario, clearing service 11 required two cash calls already.

We also note that the FSB’s prior interconnectedness paper[6] flagged a significant overlap of clearing memberships across many CCPs. This interconnection should be considered when analyzing the performance risk of cash calls, e.g., the risk of cash calls at multiple CCPs simultaneously.

Variation Margin Gains Haircutting

We made the point in the past that VMGH is procyclical, and therefore believe that VMGH must be used as a last resort and should be subject to safeguards and regulatory oversight. Further, tools like VMGH do not provide the right incentives for the CCP itself, as it enables the CCP to allocate losses to others. Therefore, it should only be used with safeguards, for suitable products and in conjunction with position rebalancing tools that ensure that the quantum of losses has been determined and the use of VMGH would be limited.

To ensure alignment of incentives, at a minimum there needs to be a sizeable second tranche of SITG contributed by the CCP prior to the use of VMGH as well.

We agree that market confidence in clearing could be damaged if a tool like VMGH has to be used. We also believe this is the same for all tools in recovery and resolution: If a CCP required recovery or resolution, confidence in clearing generally will be harmed, not only for the CCP in question.

Initial Margin Haircutting (IMH)

We fully agree with the assessment of this tool, from the issues in BAU to the contradiction of contractual and statutory protections, the incentive to make as much collateral as possible

[6] https://www.fsb.org/wp-content/uploads/P090818.pdf

bankruptcy remote, which might harm the CCP's liquidity management. IMH also has the potential to exacerbate market stress, as the IM that was haircut must be replaced immediately.

Forced Allocation

We think forced allocation and partial tear up should not be in the same category. Both are tools to regain a matched book, but work very differently and have very different advantages and – in the case of forced allocation – disadvantages.

Forced allocation would add risk to clearing members' cleared positions, which could be transactions these members may not be able to risk manage in extreme market conditions. Forced allocation could also be inequitable and there is a danger of allocating positions to members that the resolution authority thinks can bear them, which would be arbitrary at best and could be made in a way that intentionally favors certain classes of clearing participants over others. Allocation would likely be to clearing members only and not necessarily to the participants that introduced the transactions in question to the CCP.

Partial Tear Up (PTU)

In contrast to the above, PTU allocates transactions to the firms that introduced similar transactions to the CCP and therefore more appropriately aligns incentives. Positions are torn up pro-rata amongst all counterparties who have trades on the opposite side of the defaulter's positions and hence PTU is more equitable than forced allocation. Finally, the risk of firms with torn-up positions decreases, at least at the CCP, compared to forced allocation.[7] As with other recovery and resolution tools, while PTU is the "least bad" position allocation tool, it should still be used in a very limited manner with appropriate safeguards and compensation, at least NCWO compensation.

For a more detailed discussion of forced allocation and PTU, please see our paper "Partial Tear-Up: Comparison to other rebalancing tools and how the tool could evolve"[8].

Writing down of liabilities

While this tool appears to provide more resources to resolution authorities, this in reality is doubtful. The majority of unsecured liabilities at a CCP are IM (if not bankruptcy remote) and the DF. Writing down IM has similar downsides than IMH, including the potential ban of IMH in many jurisdictions. Writing down the DF will not help if this has already been used in a default loss scenario or will lead to no creditor worse off (NCWO) claims in a NDL scenario.

While there is no direct performance risk, there is an indirect performance risk, as both IM and DF will have to be replenished, which could be subject to performance risk.

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[7] We acknowledge that the consultation paper states that "*A partial tear-up, by reducing or, depending on the extent, removing one of the legs in a participant's hedging strategy, might lead to a participant's existing position becoming less effectively hedged or, at the extreme, unhedged.*" At the CCP level, risk will reduce though, and PTU will not add risk as forced allocation could; risk that in the best case will have to be hedged, in the worst case the firm cannot risk manage.

[8] https://www.isda.org/a/vxDgE/Partial-Tear-Up.pdf

CCP Equity

CCPs should have sufficient SITG in the waterfall to align incentives in BAU and in recovery. In the analysis of default losses in the consultation paper, eight CCPs needed to use recovery tools while two required the use of VMGH. Incentives should be aligned better to avoid such situations through meaningful levels of SITG and a second tranche of SITG to be used before other recovery resources. Resolution authorities should also use the remainder of CCP equity before any other tools are utilized, especially for NDL. The stress tests in this consultation paper have shown that CCP equity should also be right-sized to be able to absorb NDLs.

CCPs should also consider whether there should be guarantees of parental or affiliate support in recovery.

Pre-positioned resolution resources

The FSBs analysis shows that a discussion of the costs and benefits of requiring CCPs to hold pre-positioned resources for resolution is necessary. Whilst pre-positioned resolution resources would seemingly create inefficiencies by asking CCPs to hold assets that are hopefully never needed, they are effectively designed to address tail risk in the system and are similar to bail-in resources required in the banking sector. Pre-positioned resolution resources would be less procyclical in a resolution, eliminate performance risk, increase certainty of clearing, reduce moral hazard, and enhance confidence in the clearing infrastructure.

Compensation

At present, CCPs have a very limited downside risk if there are catastrophic default losses or NDL, which creates moral hazard; as nearly all losses above the SITG will be allocated to clearing participants. Clearing participants have little recourse to compensation for the losses they suffer through this process. We believe that requiring CCPs to provide clearing participants with a claim on future profits, or another form of compensation instrument from the recovered CCP, would better align incentives, be more equitable, and help promote the successful recovery of the CCP. This is particularly important as the recovered CCP would not be in a position to make these profits without the loss allocation to clearing participants.

Recapitalization

Loss allocation and recapitalization need to be considered separately. In particular, a CCP should not be recapitalized with resources obtained from loss allocation tools. The aim of loss allocation is to deal with a past crisis. Recapitalization is to provide capital to the CCP for the future. Whoever provides this capital, should also become the owner of the CCP and either receive equity in the CCP or the proceeds from any future sale.

We believe that the RA should not by default look at clearing participants for recapitalization. There are other options available that the RA should consider:

- Use of bail-in-able long-term debt to provide pre-funded resources reserved solely for recapitalization.

- Committed but unfunded capital instruments held by sophisticated, well-capitalized institutional investors unaffiliated with the CCP (which could, but not necessarily need to, include clearing participants).
- Third parties willing to buy the CCP, in the process providing capital.
- A subset of clearing participants agrees to recapitalize the CCP.

We do not believe that clearing members should participate in recapitalization via cash calls. If a cash call or any other tool like VMGH are used for recapitalization despite the concerns listed above, clearing participants should either receive compensation instruments or outright equity in the CCP. At minimum, recapitalization needs to be covered by the NCWO safeguard.

Next steps

We welcome the proposed next steps, including widening of the analysis to entities that were not included in this consultation paper.

We also welcome the plan to review costs and benefits of alternative financial resources and tools for CCP resolution. This analysis should include pre-positioned resolution resources, CCP equity and compensation of clearing participants.

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About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 980 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C.

FIA's mission is to:

- support open, transparent and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

As the leading global trade association for the futures, options and centrally cleared derivatives markets, FIA represents all sectors of the industry, including clearing firms, exchanges, clearing houses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry.

About IIF

The Institute of International Finance is a global association of the financial industry, with close to 450 members from 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks.