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Secretary-General
Financial Stability Board
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CH-4002, Basel
SWITZERLAND

Date: 17 October 2016

Dear Sir

IA Response to the FSB Consultative Document "Essential Aspects of CCP Resolution Planning" dated 16 August 2016

The Investment Association is grateful for the opportunity to respond to your consultation paper "Essential Aspects of CCP Resolution Planning" ("the CP").

We would like, first, to commend the FSB for its work to tackle the risks to financial stability posed by a crisis at a CCP, in particular the work to elaborate the FSB's "Key Attributes" and "FMI Annex" for CCP resolution.

This response reflects our members' views as informed by their fiduciary duties to their investors, who – as the counterparties to the derivatives agreements concerned – are directly impacted by the policy proposed in the CP.

End-investors are individuals with savings and pensions and are also tax payers. They have a direct interest in ensuring an effective and fair regime for recovery and resolution of CCPs. They are also major users of CCPs.

As fiduciaries of investors, our members have supported the post-crisis mandatory use of CCPs in the expectation that investors' savings in turn are safeguarded by the infrastructure and their rights are protected.

An effective regime for central clearing can strengthen investor confidence. Investor confidence also underpins financial stability. A loss of confidence leads to reduced investment and investor flight which can exacerbate a crisis. We respectfully ask that the FSB take the end-investor interest fully into account in finalising the policy outlined in this CP.

Yours Faithfully

A handwritten signature in black ink, appearing to read "Angus Canvin". The signature is fluid and cursive, with the first name "Angus" written in a larger, more prominent script than the last name "Canvin".

Angus Canvin
Senior Adviser

ANNEX I

CONSULTATION RESPONSE

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association is the trade body that represents investment managers doing business in the UK. Our 200 or so members collectively manage through their businesses in the UK over £5.7 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

We are the second largest investment management trade association in the world by assets under management (AuM) of our membership.

More information can be viewed on our [website](#).

INTRODUCTION

Asset management, derivatives and CCPs

Investors make significant use of derivatives, which they are rightly permitted to do (e.g. under UCITS legislation), whether for hedging purposes or to express an investment view. At the same time, in the EU EMIR requires mandatory central clearing of many derivative categories, meaning investors – Europe's tax payers saving for life's eventualities and pensioners – must use CCPs for these derivatives. Hence The Investment Association – representing the asset managers, which manage these investors' investments, including in derivatives – takes an interest in the regulation of CCPs, including CCP recovery and resolution ("R&R").

Unlike CCPs and clearing members (CMs), which benefit commercially in several ways from mandatory central clearing¹, CM clients/end investors pay for mandatory central clearing. This has implications for the funding of CCP recovery and resolution. Consistent with the principle that no taxpayer money should be at risk, it has been suggested that the private sector participants, which benefit commercially from central clearing, should collectively bear the cost of CCP recovery and resolution. This rules out the buy-side.

The obvious source of recovery and resolution funding from those that benefit from central clearing is, of course, the CCP's *ex ante* resources: the "waterfall", including initial margin of any defaulting member and default contributions from participants, as well as the CCP's own capital. Each of these layers of protection are provided by the entities who are earning a return for the provision of the clearing services. It follows that CM client/end investor property (e.g. margin) should not fund CCP recovery and should only be available in

¹ For example, CMs earn fees and other income through providing clearing services. They also benefit from the multilateral netting resulting from the CCP becoming the counterparty to every centrally cleared derivatives trade. The commercial benefits to CCPs are self-evident.

resolution consistently with ordinary principles of insolvency, in particular, the principle that no creditor would be worse off than under an ordinary liquidation ("NCWO" principle).²

Where a CCP is threatened by CM default(s) (we refer to this sort of crisis as a "CM default crisis" in distinction to a business disruption crisis, such as might be caused by cyber-attack or fraud), the management of that crisis requires careful coordination of the bank recovery and resolution measures taken concerning that CM and the crisis measures for the CCP. Recovery measures for the CCP should avoid contagion to other CMs and not exacerbate the difficulties of the CM(s) under threat. Similarly, recovery measures for the CCP should not threaten financial stability in other ways, such as by embedding perverse "first-mover" or similar incentives through threatening end-investor property in the form of margin.

Use of Margin

The role of a CCP is to mitigate bilateral counterparty credit risk. This is achieved through the benefits of multilateral netting and by the collection of margin. In normal market conditions CCPs substantially reduce counterparty credit risks. However, CCPs concentrate counterparty risk in systemic size. Their systemic size makes it vital that there be:

- Clarity as to the point at which they are no longer viable ("point-of-non-viability"/"PONV"); and
- Decisive intervention by resolution authorities at that point.

Once a CCP has exhausted its substantial resources (the waterfall), it will have failed its most important function: modelling risk to a standard that gives the market sufficient confidence to go on using it. Indeed, it is worth considering how realistic it could ever be to "recover" a CCP pushed to insolvency by reason of CM default(s), given the profound failure of the market in the asset class in question that would see the CCP's going-concern/waterfall resources consumed. There would be doubt that any CCP could accurately measure and manage risk arising from that asset class post-recovery.³

This is why the Investment Association supports clear resolution measures, but not open-ended recovery attempts. We should not presume that continuity of CCP services is the preferred option of end-investors. Indeed, beyond utilisation of the waterfall we see very few appropriate recovery measures (e.g. auctioning the defaulting clearing member(s) positions with participation beyond surviving CMs; transfer of non-defaulting CM client/end investor positions to non-defaulting CMs)⁴.

The function of initial margin (IM) posted by an end investor in derivatives to its CM is to provide the CCP with protection in the event of default by the CM with respect to transactions initiated by the end investor (the client of the clearing member): it is security for the performance by the CM and the end investor of their contractual obligations. It represents the *potential* change in market value of a derivative. End-of-day margin payable by the CCP to anyone with a mark-to-market gain ("variation margin (VM) gains" - VMG) merely reflects current exposures resulting from actual changes in market prices, i.e. VMG represent the *actual* change in market value of a derivative. Margin is the property of the CM client/end investor and is, therefore, qualitatively different from both CCP capital and CM participation in loss mutualisation, which are both specifically targeted to bolster the CCP's solvency.

² NCWO embodies a fundamental human right: protection of property (see e.g. Article 1 of the first Protocol of the European Convention for the Protection of Human Rights and Fundamental Freedoms)

³ In contrast, recovery is conceptually feasible where a CCP is in difficulty because of cyber-attack, fraud or other operational issue, where "recovery" will involve measures akin to business continuity measures, rather than running through the waterfall.

⁴ These are really default management measures. Porting to non-defaulting CMs should have been done BEFORE the CCP is in distress (it is unclear what good it could do subsequently) and the auction process is often done before the assessments are allocated to the clearing members.

As margin covers end investor default (and, by extension, CM default – a double default), it is essential (especially in a time of crisis, when confidence will have been hit hard) that the IM and VMG of non-defaulting CMs - and of CM client/end investors - are protected from confiscation (“haircutting”) in any crisis response. Otherwise, segregation of margin would be in vain and all margin – CM and end investor – would be commingled in the sense that all would be similarly available for seizure.

It is not possible to predict the size of any shortfall at a CCP threatened by CM default(s), nor, therefore, the amount of margin at risk of haircutting, because you would be dealing with a systemically unstable situation. Assuming that the CCP had modelled its waterfall properly (including meeting the IOSCO standard), a failure would in practice arise from the collapse of several CMs, meaning additionally that other CCPs would be in trouble simultaneously, as well as, potentially, other market participants (including other CMs). Imposing an uncapped liability on end-investors (via open-ended haircutting of IM and/or VMG) at such a time would exacerbate that systemic uncertainty. That prospect would incentivise investors not only to run from a CCP that was perceived to have any weakness relative to others, but also to re-evaluate their exposures in other capital markets – and this at a time of profound financial crisis - potentially propagating the crisis throughout the financial system.

IM should never be used as a recovery tool in a crisis. Using IM would leave the CCP more vulnerable to further CM default, making problematic their ability to resume business, even if otherwise successfully “recovered” (unless the shortfall in IM was made good, but that would likely only be possible from public moneys – contrary to the understandable reluctance by the authorities to use taxpayer funds to rescue a CCP – given the sort of crisis that would be underway). Taking IM off the table would also provide additional protection against contagion to other CMs.⁵

VM is also the property of end users; it does not represent gains that accrue to the CCP or CM. Haircutting VMG introduces unlimited liability at a point in time when the CCP has proven to be incapable of modelling risk, because neither the quantum of VMG nor the number of haircuts to VMG are knowable *ex ante* and may be very large given the potential market moves in the sort of financial crisis that would bring down a CCP. VMG haircutting also unfairly penalises end-investors as against CMs, for it is in practice these end-users of CCPs – with their directional positions in derivatives – that would suffer loss from haircutting VM. CMs, by contrast, will tend to have a “flat” book, as their role as intermediary naturally gives rise to more risk-position offsets. To the extent that the pension and insurance fund end-investors use derivatives to hedge exposures on underlying investments, haircutting VMG will increase their market exposure. This could exacerbate the crisis, as these end-investors sought to support their ability to meet their liabilities.

Therefore, VMG haircutting should only be considered as a measure of last resort subject to the following comprehensive layering of protections to protect against real-economy losses⁶:

1. CCP resilience is addressed
2. strict limit on the time for “recovery” measures after the exhaustion of the waterfall: a matter of days only (depending on the product concerned, CCP and other relevant factors);
3. an *ex ante* cap or limit on the potential loss to end investors;
4. a commitment to compensate those investors (which must be robust, i.e. sure to be paid by viable stakeholder(s)); and

⁵ CCP recovery measures should not inadvertently increase risks to financial stability. Threatening margin not only incentivises stability-threatening behaviour by end investors, it may threaten the viability of CMs, at precisely the time – in the midst of an extreme financial crisis – that protection of CMs would be an important financial stability imperative.

⁶ VMG haircutting poses additional problems for use of derivatives by UCITS: use of UCITS assets for securing third parties’ obligations is prohibited; how could a prospectus describe the risk of VMG haircutting?

5. the CCP's resolution authority controls any VMG haircutting and is tasked to take account of the interests of investors/end-users in exercising this control

In summary:

IM haircutting

1. IM is calibrated to cover own default risk, not that of other participants
2. IM would need to be replenished very swiftly (within days), in order for the clearing service concerned to continue
3. This might further destabilize CMs, end-users and the entire financial system, in a CM default crisis
4. IM haircutting creates liquidity and procyclicality risk on the CCP participants
5. CCP have unilateral ability to increase IMs in an unlimited way. IM haircutting risk would be neither measurable nor manageable for participants.
6. CCP R&R should not disincentive clearing over bilateral transactions. Under bilateral transactions, IM is protected through pledges and custodian agreements. Haircutting IM on cleared transactions would strongly disadvantage clearing over bilateral OTC
7. Therefore, IM haircutting should be taken off the table

VMG haircutting (VMGH)

8. Variation "margin gains" are actually the profit of a given end-investor such as a pension fund
9. Participants with VMG are not better off than those bearing losses; derivatives are used for hedging purposes, so any VM hedging gain would compensate underlying loss and vice versa
10. Therefore, VMGH is not neutral for participants (as it leads to temporarily unhedged positions)
11. End-investors who fear they will be subject to profit appropriation through VMGH will rationally seek to rapidly close out positions, which is potentially destabilising on a system-wide basis
12. VMGH also risks cascading defaults as participants expecting VM payments to cover hedging or other costs may not be able to fund the unexpected shortfall
13. It should never be available to a CCP as a recovery tool, but should only be available to resolution authorities
14. VMGH are only measurable and controllable to the extent they are capped or limited in time (to allow for assessment of gap risk)
15. Participants subject to VMGH should receive a senior claim against the CCP and its successors for the full amount of the VM taken from them
16. VMGH risks perversely incentivizing CMs: to push the CCP to use VMGH once the default fund is exhausted (or close to exhaustion), in order to recover gains from client VMGH during the auction process

CCP resilience and resolution are key

Of course, we share with other stakeholders (CMs and CCPs) and the public authorities the goal that a CCP should have sufficient ex ante resources/ waterfall in place ahead of any crisis: the CCP must be resilient to crisis. In addition, CCPs need to be incentivised further to protect the interests of their users (CMs and end investors). CCP "skin in the game" (or capital; SITG) should be substantial, therefore, even if this gives rise to higher clearing costs, which should of course be measured against the monopolistic revenue-making ability of a CCP.⁷ The quantum of capital/TLAC for CCPs is best sized through a well-designed stress-testing regime (incorporating a better understanding of the scenarios in which they would face difficulty).

⁷ However, there is a tension between CCPs providing a market utility (suggesting utility-level revenues) and the cost of central clearing.

But above all, there needs to be a plan to close any CCP that was discredited, with losses shared fairly and definitively.

The resolution regime should give the resolution authority(-ies) significant discretion as to how they close a failed CCP (or failing clearing service, if just one service is affected and the rest of the CCP can be saved)⁸, but always subject to NCWO.

When a CCP has failed, it should be required to implement a resolution plan quickly – subject to oversight/control by the resolution authority – with a clear and rapid process to limit end-user losses and contagion to the real economy, along with a timely and orderly repayment of margin (subject to NCWO). Time would clearly be of the essence (as it is for recovery post waterfall exhaustion).

End-investors might best be protected through the transfer of their positions (and related IM and unpaid VMG) to a viable CCP(s). This approach – prioritising “position good” and minimising replacement of positions in stressed market conditions – might best promote the wider public interest. It requires that both CCPs and CMs are able to transfer non-defaulting positions rapidly in a crisis.

The “position good” approach would avoid, in a stressed market, re-hedging by end investors that might increase systemic risk (and would be very difficult under crisis conditions). In contrast, a close-out approach would lead to substantial unhedged risks in investor portfolios (potentially in breach of risk, capital or regulatory constraints).

Alternatively, the public interest might be better promoted by rapid close-out of positions to minimise end-user losses and contagion to the rest of the system – a so-called “money good” approach. Resolution authorities will need the flexibility to deal with the crisis at hand.

The resolution authority should have the power to suspend the mandatory clearing obligation⁹ – as, indeed, should the authorities managing a crisis threatening the CCP, even ahead of the waterfall being exhausted – so as to allow market participants the greatest flexibility to manage their risks (e.g. through bilateral derivatives, if they so choose). This should be financial stability enhancing, as it gives market participants – including end investors and their asset managers – timely opportunity to mitigate their risks.

ANSWERS TO THE CP QUESTIONS

Q1. Does this discussion note identify the relevant aspects of CCP resolution that are core to the design of effective resolution strategies? What other aspects, if any should authorities address?

We refer to our preliminary remarks on a well-designed recovery and resolution regime for CCPs.

Incentive effects of resolution strategies

Q2. What is the impact on incentives of the different aspects of resolution outlined in this note for CCP stakeholders to support recovery and resolution processes and participate in central clearing in general? Are there other potential effects that have not been considered?

Our preliminary comments discuss the risk of perverse incentives in a poorly designed CCP R&R regime. We urge policy makers to reinforce resilient incentives through, for example, SITG of CCP owners themselves. Recovery and resolution tools should not disincentive CCP risk management through loss transfers.

⁸ Or implement some other resolution action, such as transfer to a “bridge CCP” or another existing CCP(s).

⁹ As implemented by “EMIR” in the EU

Timing of entry into resolution

Q3. What are the appropriate factors for determining timing of entry into resolution? How might a presumptive timing of entry (or range of timing), if any, be defined in light of the criteria set out in the FMI Annex to the Key Attributes? If defined, should the presumptive timing of entry be communicated to the CCP and its participants?

All profit making entities participating in markets, including CCPs, should be allowed to fail while ensuring protections are in place to avoid systemic risk and to protect end-users. A resolution plan that focuses on a rapid and complete wind down of the failing CCP's positions, along with a timely and orderly repayment of margin is preferable to a recovery plan that uses customer margin to extend the state of a failed or failing CCP: "throwing good money after bad". The exact timing of the wind down should be one area on which international consistency is sought.

A rapid liquidation and return of margin would minimise end-user losses and would give market participants the option to re-establish positions at a viable CCP, use other instruments to hedge risk or remain unhedged, if the credit exposure to CCPs is viewed as greater than the market exposure that is being hedged. Authorities should have the power to suspend the clearing requirement temporarily to enable market participants to re-establish their hedging trades on a bilateral basis.

By definition, the failure of a CCP reflects a flawed risk management process which in turn will impact customer confidence in the abilities of the CCP on a forward-looking basis. Some may argue that a CCP failure could be the result of unexpected adverse market wide events, and in such a situation a CCP's failure may not be the result of a flawed risk management process. However, given the primary function of a CCP is to size IM, default funds and capital amounts in a manner so as to maintain sufficient resources even in unexpectedly adverse environments, we believe such a failure, even in extreme market conditions, would likely have a significant negative impact on customer confidence in the CCP.

CCP failures will most likely arise where a CCP is unable to secure sufficient interest to cover the positions guaranteed or owned by a defaulting CM or where the cost of covering those positions would result in losses that exceed the resources available to the CCP. One way to help mitigate that risk would be to allow creditworthy market participants who are not clearing members to participate in the auction process.

Where a CM has defaulted other CMs may be hesitant to take on additional risk and may not bid aggressively or at all. We do not see any meaningful downside to increasing auction participation and firmly believe expanding the participants eligible to bid in the auction process is highly likely to improve auction results. The criteria for non-clearing member participation in the auction process should be established and published as part of the CCP's recovery and resolution plans, which would allow both the CCPs to identify potential participants and for those participants to take preparatory actions in a measured fashion rather than during the midst of a crisis.

We strongly recommend that resolution authorities play a role early in the recovery process before all CCP assets and default resources are exhausted. The resolution authority should then determine whether recovery or resolution of a CCP would be in the public interest and if the CCP had sufficient resources at its disposal to be recovered. If recovery is the chosen option the resolution authority should be responsible for organising another final round of cash calls on CMs before the profits of the end-investor / real economy are haircut.

However, if the resolution authority determines that the recovery measures available to the CCP are not reasonably likely to return the CCP to viability within the timeframe required to enable continued compliance with applicable legal and regulatory requirements, or that they are otherwise likely to compromise financial stability, then the CCP should be taken into resolution.

Adequacy of financial resources in resolution

Q4. Should CCPs be required to hold any additional pre-funded resources for resolution, or otherwise adopt measures to ensure that there are sufficient resources committed or reserved for resolution? If yes, what form should they take and how should they be funded?

It follows from our preliminary comments that *ex ante* funding of the CCP to protect it in a crisis should be the preferred source of funding for resolution. Moreover, investor confidence in clearing would be reinforced by a renewed focus on CCP resilience. Robust stress testing of CCPs, additional transparency on CCP risk management practices and increasing CCP resources would, in combination, help to reduce the risk of CCP failure. Policy makers should establish harmonised risk capital standards across CCPs.

We welcome the CPMI-IOSCO work already underway to review the adequacy of CCP resources. CCPs are for profit entities that carry out the function of public utilities. Higher volumes of cleared trades increase the CCPs revenues, but also increase the risk they represent.

Strengthening the “default waterfall” should be a priority. Standardised stress tests should be used to test and disclose the strength of the CCP’s default resources. A risk-based CCP contribution to default resources would help to ensure CCPs do not take on excessive risk in order to drive revenues. “Risk” in this context must be more broadly defined than net market risk, which, during normal market operations, a CCP manages to zero. Risk must include how much market risk a CCP could inherit from a CM default, in addition to operational risks and credit risk from settlement, custody and investment activities.

The CCP could be required to contribute more than a minimal amount that is risk-based. That contribution might be the lower of either a fixed percentage of the fund or the largest single clearing member contribution, for example, but we suggest CPMI-IOSCO lead in elaborating this. This risk-based contribution would also promote broader and more diverse CM membership of the CCP and manage concentrated exposure to a single CM. Having more SITG will incentivise the CCPs to have robust risk management and would align incentives between the CCP, clearing members and market participants.

Ideally, CM replenishment obligations should be legally sound and enforceable, so that this resource is available when it falls due. In practice, we recognise that in a CM default crisis – with two or more G-SIBs failing – the authorities may be loath to allow replenishment, lest the remaining CMs are destabilised further. This consideration argues for early intervention by the resolution authority in a CM default crisis, well before calls on CMs could themselves threaten financial stability.

Q5. How should the appropriate quantum of any additional CCP resources be determined? In sizing the appropriate quantum, what factors and considerations should be taken into account? Do your answers vary for default and non-default losses?

CPMI-IOSCO should lead the work determine the appropriate quantum of any additional CCP resources once the current round of consultations has finished and there is greater clarity on the global standards for CCP resilience, recovery and resolution. We shall consult our membership and feed in their views at that point.

Q6. Should resolution funds external to the CCP be relied upon? If so, how should such funding arrangements be structured so as to minimise the risk of moral hazard, including for CCPs with significant cross-border participation? Where these are pre-funded, how should the target size be determined and which entities should be required to contribute?

The liquidity necessary in resolution should come exclusively from central banks, on standard market terms, including the requirement for high quality liquid collateral. Without access to central banks, liquidity strains would likely compromise CCP resolution and have a negative impact on financial stability. We do not support the use of VMGH or any similar tool for liquidity purposes.

Tools to return to a matched book

Q7. What factors should the resolution authority consider in choosing and exercising tools to return the CCP to a matched book? Is one (or more) of the tools for restoring a matched book preferable over others and if so, why?

As we proposed in our preliminary comments, the public interest¹⁰ may require resolution of the CCP (or of the affected clearing service(s)) at any point in a crisis at a CCP, particularly in a CM default crisis. In other words, the point of non-viability, when resolution should occur, will depend on the crisis itself, the CCP and clearing service(s) concerned, the depth and extent of the crisis across the financial system and other relevant factors. Nevertheless, it is generally assumed that a CCP will be in resolution after the auction has failed to return the CCP to a matched book. If for some reason resolution commences prior to completion of the auction, then the resolution authority should have the power to continue the auction for as long as valid bids are submitted.

In the event that an auction fails prior to resolution or in resolution, we support the voluntary use of partial tear-ups to return a CCP to a matched book. Partial tear-ups should also be subject to the approval of all parties – the CCP, clearing members, end-users and the resolution authority. No tool to return to a matched book should incentivise a participant to prefer recovery over resolution, or vice versa. These tools should enable all stakeholders to assess their risks and manage them, so they should be disclosed *ex-ante*.

We oppose forced allocation as a means of returning a CCP to a matched book. Forced allocation requires clearing members to take on positions that they may not be suited to risk manage in extreme market conditions.

Clearing participants should be compensated with senior debt claims should they suffer losses from partial tear-ups, not least so as to give them the benefit of NCWO protections.

Q8. Should any tools for restoring a matched book only be exercisable by resolution authorities? If so, which tools and subject to what conditions?

See the answers to Q 9 and 10 below.

Allocation of losses in resolution

Q9. What are in your view effective tools for allocating default and non-default losses and what are the pros and cons of these tools? Should initial margin haircutting be considered as a tool for the allocation of losses in resolution? Is

¹⁰ The obvious public policy imperative is to preserve financial stability, but other priorities – such as to incentivise saving for retirement – may also determine the wider public interest and, consequently, the particular measures and timing of policy actions in the crisis.

one or more of the tools preferable over others? What are your views on the use of tools to restore a matched book as a means of loss allocation?

Q10. Which, if any, loss allocation tools should be reserved for use by the resolution authority (rather than for application by a CCP in recovery)?

In our preliminary comments we explained the need for early intervention by the resolution authorities in a CCP crisis, including in recovery. We suggest that once voluntary and committed forms of capital are exhausted, only resolution authorities should oversee loss allocation - be it through partial tear-ups to restore a matched book or through other loss allocation tools in recovery and resolution. Only those tools available at the top end of the waterfall structure – the auction of positions held by the defaulter, the defaulters IM & VM within their House accounts, Default Fund contribution, CCPs share capital and the remainder of any funded default fund should be available as part of the CCP's recovery strategy. VMGH and IM haircutting should be reserved for use by the resolution authority. Depending on the nature of the CCP crisis, the wider public interest, including preserving financial stability, may require the resolution authority to oversee the use of any particular tool.

There are a number of issues with cash calls:

- a. Cash calls may affect incentives for risk management
- b. Cash calls create liquidity and procyclicality risk on the CMs
- c. Cash calls may threaten the viability of the affected CM propagating systemic risk, with the result that authorities should be realistic about the likelihood that they could use this tool in a CM default crisis at the CCP
- d. Cash calls should only be made on liquidity regulated entities such as CMs and not on indirect participants, which may not have experience in managing such risks

Concerning non default losses:

- a. A CCP is, in effect, a pass through between market participants
- b. As such, market participants should not be affected by CCP business activity
- c. Business losses should be borne by shareholders exclusively
- d. The CCP regulatory capital requirement should be calibrated to withstand CCP business risk
- e. End-investors are exposed via clearing agreement indemnity provisions to non-default losses
- f. Hence the non-default R&R regime should ensure that losses are allocated in a final and legally binding way to the CCP, CMs and end users and that losses cannot be transferred to end users via indemnity provisions in bilateral contractual clearing agreements

Q11. How much flexibility regarding the allocation of losses is needed to enable resolution authorities to minimise risks to financial stability? For example, to what extent should a resolution authority be permitted to deviate from the principle of *pari passu* treatment of creditors within the same class, notably different clearing members in resolution? What would be the implications of a resolution strategy based primarily or solely on a fixed order of loss allocation in resolution set out in CCP rules vs. a resolution strategy that confers discretion to the resolution authority to allocate losses in resolution differently to CCP rules?

The principle of *pari passu* treatment is fundamental to NCWO and public confidence in finance. Therefore, any deviation from *pari passu* could leave the resolution authority open to future claims, especially if it destabilises creditors/CMs further. In addition, we find it hard

to imagine any deviation from *pari passu* treatment as in the interests of end-investors: their rights, and more importantly savings, need to be protected to ensure that they have confidence in the markets and in the wider public interest.

Q12. What are your views on the potential benefits or drawbacks of requiring CCPs to set out in their rules for both default and non-default losses:

One benefit of clarity *ex ante* is to publicise the protections given to the underlying investors by the subordinate exposure of other participants – CCP shareholders, CMs – in the liability stack.

Non-default losses

Q13. How should non-default losses be allocated in resolution, and should allocation of non-default losses be written into the rules of the CCP?

Non-default losses, such as operational or human error, should be covered by additional capital held by the CCP, guarantees, or binding commitments to subscribe for further equity from shareholders and, where available, insurance. This is to ensure that the CCP and its shareholders have SITG and that they have robust operational risk management processes in place to minimise errors and fraud.

Q14. Aside from loss allocation, are there other aspects in which resolution in non-default scenarios should differ from member default scenarios?

As stated above in answer to questions 12 and 13, the shareholders should be the first part of the waterfall structure in a non-default scenario.

Application of the “no creditor worse off” (NCWO) safeguard

Q15. What is the appropriate NCWO counterfactual for a resolution scenario involving default losses? Is it the allocation of losses according to the CCP’s rules and tear-up of all the contracts in the affected clearing service(s) or liquidation in insolvency at the time of entry into resolution, or another counterfactual? What assumptions, for example as to timing and pricing or the re-establishment of the CCP’s matched book, will need to be made to determine the losses under the counterfactual?

Q16. What is the appropriate NCWO counterfactual for a resolution scenario involving non- default losses? Is it the liquidation of the CCP under the applicable insolvency regime, assuming the prior application of any relevant loss allocation arrangements for non-default losses that exist under the CCP’s rules or another counterfactual?

Q17. How should the counterfactual be determined in cases that involve both default losses and non-default losses?

For default losses and non-default losses and for cases that involve both, we believe that the appropriate NCWO counterfactual is liquidation under the applicable insolvency regime at the time of resolution.

Equity exchange in resolution

Q18. Should CCP owners' equity be written down fully beyond the committed layer of capital irrespective of whether caused by default or non-default events?

Yes, the shareholders of a CCP should be completely wiped out in a resolution.

Q19. Should new equity or other instruments of ownership be awarded to those clearing participants and other creditors who absorb losses in resolution?

CCP rulebooks should provide senior debt claims for clearing participants and end-users who suffer losses beyond the CCP's funded and unfunded default resources, both in CCP recovery and in a CCP resolution. This would mean compensating losses incurred through partial tear-ups and VMGH through providing senior debt claims, which would be paid with future CCP earnings prior to any such profits flowing to shareholders. If resolution does occur, the claims should be bailed-in for equity as part of a recapitalisation. It is crucial that the holders of the senior debt claims have recourse beyond the defaulting CM's estate.

Cross-border cooperation

Q20. What are your views on the suggested standing composition of CMGs? Should resolution authorities consider inviting additional authorities to the CMG on an ad-hoc basis where this may be appropriate?

There is a balance to be struck between the standing composition of a CMG and its workability. Ideally, CMGs should include - even if only in a consultative or observer capacity - the supervisors and resolution authorities of:

- major clearing members
- the central banks of issue of the major currencies cleared
- trading venues operating with the CCP.

Where a particular client or indirect clearing member accounts for a significant share of the CCP's business, it is arguable that their relevant supervisor and resolution authority should also be involved.

It is important that the public authority, which can suspend mandatory clearing obligations, should be involved in recovery and resolution, including on the CMG – see also Q 24.

We suggest that these authorities participate in regular "fire drill" exercises.

Q21. What should be the nature of engagement with authorities in jurisdictions where the CCP is considered systemically important, for the purpose of resolution planning and during resolution implementation?

Where the CCP is systemically important in a jurisdiction, the relevant authorities from that jurisdiction should be involved in the CMG, even if only in a consultative or observer capacity.

These authorities should be involved in resolution planning (including resolvability assessments) and should be kept informed of any developments that may affect financial stability in their jurisdiction.

We suggest that these authorities participate in regular “fire drill” exercises.

Q22. Should CCP resolution authorities be required to disclose basic information about their resolution strategies to enhance transparency and cross-border enforceability? If so, what types of information could be meaningfully disclosed without restricting the resolution authority’s room for manoeuvre?

Cross-border enforceability should certainly be assessed in advance, but this may not necessarily require information sharing with other regulators – it could just require the CCP to obtain appropriate legal opinions.

Cross-border effectiveness of resolution actions

Q23. Does this section of the note identify the relevant CCP-specific aspects of cross-border effectiveness of resolution actions? Which other aspects, if any, should also be considered?

N.A.

Q24. What should be the role, if any, of the suspension of clearing mandates in a CCP resolution and how should this be executed in a cross-border context?

For the reasons outlined in our preliminary comments we believe that there should be a process for promptly suspending (i.e. within one day) mandatory clearing in a CCP crisis, including well before resolution.

Many investors use cleared derivatives for hedging purposes. They may need quickly to replicate hedges “torn up” as part of the resolution process to avoid breaching limits or investment mandates, or to avoid taking unwanted exposures. It is not clear that there would be sufficient clearing capacity at another CCP during a period of market stress, and CMs will often have discretion to reject trades. Hence it is important that market participants at least have the option to hedge bilaterally.

In the EU the cross-border context would ordinarily require the involvement of ESMA.

Public authorities responsible for mandatory clearing mandates should:

1. ensure that they are ready to suspend the mandate in a CCP crisis quickly (i.e. within one day); and
2. on a regular basis identify CCPs that are key to market participants’ ability to comply with any clearing mandate for which that regulator is responsible and, if that CCP is located in another jurisdiction, inform the appropriate authority in that jurisdiction.