

Secretariat to the Financial Stability Board (FSB)
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FSB Discussion Note: Essential Aspects of CCP Resolution Planning

Nasdaq Clearing AB (Nasdaq Clearing) is a leading, EMIR-authorized CCP, providing central counterparty clearing services for a broad range of markets and asset classes. Our offering includes clearing of both exchange traded and OTC derivatives contracts as well as a repo clearing service.

Nasdaq Clearing appreciates the opportunity to provide comments on FSB's Discussion Note on Essential Aspects of CCP Resolution Planning. We follow the developments on recovery and resolution closely and believe that FSB's Discussion Note provides a balanced approach towards resolution planning; it highlights some of the key issues that need to be addressed in an effective CCP resolution planning in order to not disrupt the recovery process.

Objectives of CCP resolution

Q1: The over-arching goal of any recovery and resolution planning should be to focus on the going concern of the CCP. To implement a new bilateral market infrastructure during extreme market stress will not benefit the financial system or the society as a whole. Hence, the most important aspect should be to ensure that the right incentives and tools are in place to restore clearing.

Resolution strategies

Q2: Nasdaq Clearing agrees with the identified resolution strategies and the elements to consider when developing a resolution strategy. It is especially important to ensure that the resolution strategy does not undermine the incentives for the CCP and its members to support recovery. Hence, resolution strategies should motivate all participants to cooperate in order to avoid resolution. In order for that to work properly, CCPs must be given sufficient time to execute their recovery plans in a credible manner. Also, resolution strategies should not alter the current incentives structure established through the CCP default management and recovery processes.

Timing of entry into resolution

Q3: The timing of the entry into resolution is probably the most difficult aspect of the whole recovery and resolution process. Resolution should only be triggered to secure the going concern of

critical clearing services and market stability when the CCP recovery plan has failed. To pre-define the point of failure poses several challenges; each default or non-default loss event is unique. There is limited or scarce historical experience of a recovery and resolution process that can be used as a precedent. In addition, one would need to create the right level of transparency and try to strike a balance between predictability and flexibility. If resolution is triggered too early, there is a risk that the planned recovery actions are disrupted. Our view is that the point of failure for the CCP recovery plan cannot be predefined ex-ante without too many negative effects (many of them are listed in FSB's Discussion Note). There is an inherent risk that the resolution authority would put the CCP into resolution too early or too late based on an incorrect pre-defined trigger point. Instead, the resolution authority should work closely with the CCP during the whole recovery process to be able to use their own judgement when the CCP has failed on its processes and no longer can perform its critical services in a credible manner. Nasdaq Clearing believes that pre-defined indicators of when there is an increased risk that the CCP is being placed into resolution could be defined instead of an exact trigger point to enhance the transparency.

Adequacy of financial resources in resolution

Q4: Additional pre-funded resources would have a very negative impact on the overall cost of clearing no matter who is required to provide these pre-funded resources. A requirement for additional pre-funded resources would provide an incentive for alternative business models or solutions to avoid clearing. This is in contrast with the overall goal to improve the financial stability by establishing an infrastructure built on transparency, capital requirements, CCP clearing and recovery and resolution planning. Also, to pre-fund large amounts for such an extreme event as a CCP resolution is not viable from the principle of proportionality.

Q5: CCPs are capitalized in accordance with strict rules covering simultaneous default of the two largest participants under extreme market conditions. They also hold capital for the orderly wind-down. CCPs maintain insurance and other financial resources to address a variety of non-default losses resulting from general, business and operational risks.

Q6: A better alternative than requiring pre-funded resources would be to give the resolution authority the right to perform a second cash call (in addition to the assessment power held by the CCP) when the CCP is put into resolution. This would provide the resolution authority with additional resources and a tool that would incentivize participants to support recovery actions. The circumstances under which a second cash call can take place should be pre-defined in the CCP rulebook.

Tools to return to a matched book

Q7: Nasdaq Clearing's view is that the following tools are best suited to restore a matched book: i) cash calls, ii) variation margin haircuts, and iii) partial tear-up for a limited and pre-defined set of contracts.

We do not believe that the following tools are suitable: i) full service tear-up, ii) forced allocation, or iii) initial margin haircuts. All of these tools have negative consequences that risk increasing market instability and jeopardizing the CCPs ability to continue as a going concern.

To perform a full tear-up of a service and the contracts covered by such service in an extreme market scenario will impose a lot of new risks to the non-defaulting participants (i.e. the participants that should help the CCP return to a matched book), which could lead to further defaults and an escalation of the situation. In a default of a large clearing member (i.e. the most likely event to end up in a recovery and resolution process) that is active in multiple services and markets, a full tear-up would involve the tear up of several services at multiple CCPs simultaneously, and hence, would have a wider systemic impact.

Q8: Nasdaq Clearing's view is that all tools should be available to the CCP to increase the possibility of a successful recovery process and to avoid resolution. The resolution authority could also use some of the tools as part of the resolution process, provided that these tools are not being exclusively reserved for the resolution authority.

Allocation of losses in resolution

Q9: Please see answer under Q7. From a general perspective, the tools used to restore a matched book can also be used to allocate losses. The CCP should define the purpose for which the individual tools can be used in its recovery plan. It should here be stressed that initial margin haircutting is not a good tool for recovery or resolution. Initial margin is intended to manage the exposures of the individual risk taker and should not be mutualized. In an extreme market scenario, initial margin haircutting will lead to collateral deficits that not all participants will be able to manage. Hence, it will risk pushing more participants into default.

Q10: Please see answer under Q8.

Q11: Nasdaq Clearing's view is that the resolution authority must be given flexibility in relation to the order in which it uses certain tools, in the same manner as a CCP needs this flexibility during the recovery process. CCPs must be able to execute their recovery tools as defined in their rulebooks to allocate losses in an order and manner best designed to manage the extreme scenario at the time of the losses.

The resolution authority should only be permitted to deviate from the principle of *pari passu* treatment of creditors within the same class in a limited number of cases such as during an extreme market scenario. In order to create predictability, it is preferable if the circumstances under which such deviation can take place is set out in the applicable legislation. The main principle should thus be to treat all creditors within the same class equally.

Q12: The CCP should set out the preferred approach for recovery and resolution in its recovery plan, and in the rulebook. Both the plan and the rulebook should provide the necessary flexibility for the CCP to make discretionary decisions. To the extent that there is an overlap with the CCP's recovery tools, the tools of the resolution authority can be described in the CCP's rulebook (i.e. one need to distinguish between mandatory legislation and the CCP's rulebook which effectively is a contract between the CCP and its members). We also agree that it is important that the parameters or boundaries of any discretion conferred on the resolution authority are made clear in advance to establish the range of action that the authorities might take and enable the CCP participants and other creditors to assess their exposures.

Non-default losses

Q13: We believe that a natural tool for non-default losses (NDL) is to establish a comprehensive insurance coverage. The CCP should also have capital that caters for NDL, such as general, operational and business risks losses. The challenge with NDL is that they, by their very nature, are not suitable for mutualization (apart from investment losses). Allocation of NDL should be based on the facts and circumstances of the stress scenario where losses resulting from decisions directed by the CCP should be allocated to the CCP and its owners.

Q14: From a resolution perspective the transfer of the CCP may be practical and doable if the failure of the CCP is due to non-default losses and the CCP is in need of more capital. In a member default scenario, it would be hard to sell the business without further negative impact on the market.

Application of NCWO safeguard

Q15-17: We agree with the general statement in the Discussion Note that authorities should clearly set out in advance the relevant counterfactual and the assumptions and valuation principles that should apply in assessing the losses that participants and other creditors would have borne had the authorities not intervened. We also agree that the counterfactual for the NCWO safeguard needs to reflect the specific characteristics of CCPs, the loss allocation prescribed under the CCP's rules as well as under applicable insolvency laws. However, we appreciate the difficulty in establishing such safeguards; it is by no means an exact science and has to be based on a number of different assumptions. In our opinion, the natural starting point would be the liquidation of the CCP under the applicable insolvency regime, assuming the prior application of the relevant loss allocation arrangement for both default and non-default losses. To differentiate between default and non-default losses would increase the complexity in an unnecessary way and, as mentioned in the Discussion Note, could potentially expose the resolution authority to compensation claims.

Equity exchange in resolution

Q18: It is reasonable to argue that the equity of the CCP should be written down if the CCP is placed in resolution. Hence, in order to incentivize a strong ownership of the CCP (e.g. to encourage the owners to perform capital injections during the recovery phase), it is of vital importance that the CCP is not placed in resolution too quickly without the possibility of first executing the recovery plans.

Q19: Nasdaq Clearing does not support compensation of losses through the issuance of new equity or other instruments of ownership as it would disrupt the incentives and the mutualization structure on which CCPs are based.

Cross border cooperation

Q20-21: We agree that cross-border cooperation is an important aspect of CCP resolution. However, the lead resolution authority should be the authority in the jurisdiction where the CCP is established. A college of resolution authorities would only sub-optimize the decision process in a situation where a prompt and firm decision is a pre-requisite for a successful recovery and resolution process. Hence, we believe that the home resolution authority should lead the work with support from other relevant authorities. This arrangement should be formalized through a recognition framework which

is binding on the relevant jurisdictions. The home resolution authority should also provide information to relevant authorities as appropriate during the crisis.

Q22: We believe that transparency of the resolution strategy would benefit the market. However, the need for flexibility in the execution of such strategy is also important.

Cross border effectiveness of resolution actions

Q23: Nasdaq Clearing agrees with the FSB that arrangements such as cross border interoperability and cross-margin agreements between CCPs will impact the resolution work and that it has to be carefully planned and thought through.

Q24: A temporary suspension of the clearing obligation could be useful during the resolution process. This would provide the participants of the affected CCP with the possibility to establish a relationship with other CCPs or clearing brokers in order to continue to clear the relevant contracts.

Please do not hesitate to contact us if you have any questions or if you require further information.

Yours sincerely,

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