Financial Stability Board

Essential Aspects of CCP Resolution Planning

Discussion Note issued for comment 16 August 2016

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6th October 2016

Dear Sir or Madam,

The firm of Thomas Murray wishes to thank the Financial Stability Board for the opportunity to comment on "Essential Aspects of CCP Resolution Planning," its Discussion Note issued on 16 August 2016.

Since the 2009 G20 Pittsburgh Communique, which unexpectedly put heavy reliance on central counterparty clearing to "solve" the risks inherent in over-the-counter derivatives, analysts here have examined the potential effects of this objective step-by-step. The firm's clients rely on guidance in the risk assessments we provide. No matter what the market conditions, trades must be cleared, even if an infrastructure is being closed down – and this point will be central to the commentary provided in this letter.

CCP structures and operations have been transformed since 2009 to meet the new mandate set by G20, and the OTC mix has begun to be added in size into clearinghouse books. The risk managers seem to be handling the changeover. This firm, however, remains very concerned by the cost transfers from the bilateral contracting parties to the clearinghouses, making them extremely expensive to use; and falling liquidity and shrinking collateral pools due to other regulatory changes in the financial system. A significant drop in liquidity is one of the worst indicators for the health of a capital market – in medical terms, this would be a patient running a high fever. This is not a favourable evolution of business.

Risk management in a clearinghouse does not eliminate risk; it mutualises bilateral counterparty risk for the duration of the contract. The costs of risk have been moved laterally to a more public venue.

In 2009, the clearing houses of the world did not collectively put their hands up to volunteer to take on the responsibility for OTC counterparty risk management. If memory serves us correctly, other actors in the financial marketplaces instead volunteered the CCPs. Many read the clearinghouse solution to OTC

as, effectively, the end of the bilateral contracts position problem – Thomas Murray did not. That baseline of understanding what happened then, and why, remains critical to public assessments of how these infrastructures will behave. Every party has its own interests to pursue.

The firm

Analysis of the operations of the world's post-trade capital market infrastructures and related asset custody services are the sole subject matter of this firm.

Thomas Murray was founded 24 years ago as a private limited company registered in the United Kingdom. It is owned by 90 individual investors; with no institutional ties of any kind, this position assures the independence of viewpoint that is essential for credible analytical and advisory services.

The firm's analyses cover 430+ various types of infrastructures in more than 100 marketplaces. 75 persons work for the firm, and we endeavour to provide current, detailed information to our clients. The question that led to the founding of Thomas Murray was global custody, and from there the business coverage spread by geography and line of business. Today, the firm's analytical coverage includes central securities depositories, custodians (global, national, and sub-custodian), settlement houses, clearing houses, transfer agents, cash correspondents, as well as registrars.

The firm has stepped up its monitoring of CCPs in their new environment since 2012, evaluating six kinds of risk: counterparty, treasury and liquidity, asset safety, financial, operational, and governance and transparency. Assistance has been provided to CCPs for their self-assessments against the CPMI-IOSCO Principles for Financial Market Infrastructures.

Thomas Murray believes that its extensive knowledge of financial market infrastructures, generally and globally, may give weight to the comments that follow.

General observations on the current consultation

In the text, there are several passages that refer to resolution in which the reader appears to be guided back to recovery. Certainly, recovery would be preferable to the need to wind down a market infrastructure – but guidance by the public authorities will have to be clear that beyond a certain point there can be no going back. Resolution is the term used in the name of this FSB Discussion Note. Once the decision to resolve a CCP is taken, the mechanism must be irreversible and known to be so. The text appears to waver on this point. In fact, Thomas Murray would strongly recommend ending the usage of "recovery and resolution" as a single term. The two questions need to be distinguished at every level, beginning with the language used.

There is an evident need to set out the guidelines for the moment of determining that recovery of a CCP will no longer be possible, and that the switchover to resolution becomes inevitable. It would be an extraordinarily difficult decision to take.

There is appropriate emphasis on sharing losses during resolution.

The FSB Note is less clear, however, about how the clearing function would continue during resolution and who would be in charge of clearing operations. Do the public authorities charged with the responsibility of oversight have the expertise required to continue the clearing function? Should there not be provision for this, possibly including training that is publicly communicated as an assurance to the market? Should the resolution authority create a new entity for this function, operated by it, with the explicit intention of privatising it as soon as market conditions will allow? In this sense, there may be a parallel to the "bad bank" resolution authority system, in which the loan portfolios are progressively wound down. There is a moral hazard element in stating at the outset that the government will back clearing, but that is the logical end to the G20 decision – and probably the less costly solution for taxpayers, anyway.

Even with proper training by others, the problem of porting positions to a new clearing facility must be solved. There are legal property issues that need to be addressed, as well as the difficulty of lining up in advance a second, back-up clearinghouse having to bear the costs of standing availability – and then, suddenly, to receive positions at what would inevitably be an extraordinarily difficult moment for the markets. This, in the firm's view, is the other subject area which remained too vague or entirely unstated in this Comment Note.

As matters stand, for this one critical function, the world's financial system has become terribly dependent on the continued operation of half a dozen very large clearing houses. To reduce that dependency, other actors must be trained to pick up the strands of a fraying system, if it were to come to that. And it would be helpful for the market to know that the national resolution authority would be on stand-by for continuing operations. The choice for the authorities is not an easy one: but, it seems to us that the moral hazard question has long been on the table. Was it not always implicit from 2009 in Pittsburgh, when so much OTC contract counterparty risk got switched from the banks to the capital markets? Was it not also implicit in the government backing of the bank-members of CCPs? The clearinghouse and its members are a single intertwined unit, with public support implicitly given to varying extents.

Comments on the consultation questions

Question 1- are all relevant aspects of resolution identified?

Recovery implies the ability to rebalance and continue business operations. Calling on assets during recovery should be the responsibility of the CCP itself. As a matter of its responsibilities as overseer of the market infrastructure, the recovery plan the regulator must reviewed regularly with the CCP. The clearinghouse must demonstrate that it has the right and ability to call on all possible resources from participants when a CCP is trying to recover, in other words, when it is still viewed as a going concern. Those resources must be able to be blocked, at all times and certainly *before* the CCP is determined to be in a state of resolution by the authorities.

For the reader, it is not firmly stated who "owns" the problem and the assets when a clearing house is in resolution, what sort of legal entity it would be throughout the time of unwinding and closing down –

can the CCP be made a ward of the state? Related to this, one of the troublesome areas raised in the firm's review work of the CPMI-IOSCO PFMIs is that key elements of Principle 1 on Law are often not sufficiently firmly established by legislation and jurisprudence in many of the jurisdictions the firm reviews. Resolution would be no time to be testing any of those basic matters.

In this hypothetical case, for daily operations in a clearing house being resolved, is the unwinding CCP reporting directly to the state to run off existing contracts? Does the resolution authority take on those contracts that cannot be ported within the jurisdiction or elsewhere, or are they meant to be added to the book of the CCP even as it is being unwound? How does a resolved CCP end? What / who would step up to perform this service in its place?

Question 2 – Incentive effects of resolution strategies

The incentive for clearing members to accept the authority of the state is that the clearing function is being assured, one way or another. This is fundamental for financial stability. For members of the clearing house and their clients, certainty for management of existing positions and the possibility of adding new business thus afforded by the authority is worth a great deal. Business continuity has great commercial value.

Further, the capital market is a regulated environment; all actors know that their businesses are subject to risk of regulatory change, and its accompanying costs. In this sense, there is no need to provide for any further incentive.

Question 3 – timing of entry into resolution

This firm believes that resolution authorities cannot and must not foreshadow the determination of entry into wind-down of an infrastructure. This will prove to be an extraordinarily difficult judgment based on an alignment of circumstances that will, by definition, be powerful and unique. What should matter to the market is knowing that the public authorities are closely monitoring any evolution of clearing; and that the clearing house's capital and clearing members' assets are always on the line.

For the market's users, when the moment comes it will have to be enough for the authorities to state that all efforts to recover the clearing house have failed, that it has proven impossible to restore, and the authorities have spoken with market stakeholders and determined that the infrastructure must be wound down. Responsible actors should understand the gravity of such an announcement, and know that the decision would not have been taken casually.

Questions 4-6 – adequacy of financial resources in resolution

This section seems out of place for a Note on resolution, as the title states. If resources in resolution are adequate, then the CCP would logically have been recoverable before matters got to that stage. For

Thomas Murray, this might be better put as the carryover from a failed attempt at recovery. With resolution, the market will have arrived at a very different place: the question is what resources will it have at its disposal at that moment and afterwards?

By definition, public support is implied to the full extent required to wind down all positions and find another institution to carry on the central counter-party function. This means both taxpayer money and public administration of the function to the extent required.

Understandably, the FSB cannot easily or fully state what the market expects, which is to say that *public funds will be on the line to some extent once the decision to resolve is taken*. The amount on the line cannot be known in advance. All private resources must be transferred to the public purse and losses duly allocated, limiting the cost to taxpayers. This firm cannot imagine how else financial stability could be kept.

That the public purse and administrative effort is on the line is the direct result of the Pittsburgh G20 summit, which concentrated risk in central clearing. The deterioration of clearinghouses' institutional position was exacerbated by clearing members becoming fewer and bigger due to Basel III constraints. The public purse has been on the line the other way around, in any case, via central bank support for the bank-clearing members of CCPs in the first place.

In commentary to clients, at every step of the way these likely outcomes were explained, because OTC bilateral contract risk and associated costs were being transferred, not eliminated. *In its strongest terms, Thomas Murray underscores that these were foreseeable outcomes, the kicking of the OTC-risk can down the road.* These OTC counterparty risks take on other forms.

Questions 7-8 – tools to return to a matched book

Thomas Murray believes that this section also belongs to oversight of recovery, and should not be part of a Note on resolution. The recovery plans belong to the CCP, and it must regularly demonstrate the adequacy of its planning to its overseers. If it were able to return to a matched book, it should logically be a going concern afterwards.

This firm does not believe that any tools for returning to a matched book should be left for the resolution authority alone. Even at the worst moments of risk management, if the CCP is recoverable it should be drawing on the resources it needs with tools available to it. If the CCP is not recoverable, then it will have crossed an invisible line. The same questions would then look very different.

Questions 9- 12 – allocation of losses in resolution

The small global clearinghouse community has a vivid memory of a Hong Kong court reassigning collateral held at the CCP sometime after the collapse of Lehman Brothers. Those assets were held by the clearer, and with them the clearer would have been whole after the bank's liquidation. Its margining had worked as intended, even during that very great test. The reassignment of those assets to another party was felt by many to be a judicial error caused by after-the-fact decision-making. For many, that created

both a bad taste and a gnawing sense of uncertainty that risk management by the CCP might not be enough to assure the protection of the assets given to it by member-participants. The rulebook and the legal / regulatory framework under which it was drafted, were not followed.

Thomas Murray would argue in favour of initial and variation margin being available to the resolution authority during wind-down. The argument would be that the 2009 Pittsburgh Declaration could have been interpreted by some as the transfer of risk and cost from the contracting parties to the mutualised pool of a CCP with its specialised management. Despite the high explicit cost of central clearing to shore up the risk rather than retaining uncovered positions with the opposite counterparty as was past practice, having the CCP interposed might give the impression that the risk was simply handed off for a fee. This might encourage market actors to continue to take on unwarranted risk relative to the cost of posting collateral or the use of the more easily priced and managed exchange-traded derivatives. That behaviour, if true, should not be covered by taxpayers during the resolution of a market infrastructure. Making the possible use of margin in liquidation clear to investors at the outsight might focus attention and channel risk-taking and risk-coverage to where they are actually most needed by investors.

Questions 13-17 - Non-defaulting losses and application of the "no creditor worse off" safeguard

The CCP's default waterfall must be published and readily available for market participants and their clients, because of the certainty that communication affords; and so, too, must the resolution authority's liquidation rules be easily available for public review. Whilst the firm can understand that resolution would be a most unexpected and unwelcome event, and therefore requires some flexibility, for reasons of certainty and encouraging participation in the clearinghouse –as the FSB has written in its Note – *clear rules published beforehand enable all parties to know where they stand*. As written above in this commentary, the deviation from clear rules in Hong Kong from this best practice for the operators of infrastructures and their overseers entails a different kind of cost.

In point 6.7 of the FSB Note, there would be a most helpful caveat for the authorities to follow: '… the extent of flexibility could be established within certain constraints or bounds.' Thomas Murray would encourage those constraints and bounds to be specified in advance, assuring some flexibility in a financial emergency whilst limiting the possible sense of bad surprise.

Questions 18-19 - Equity exchange in resolution

The text could be interpreted in a way that award of ownership to a new party through equity exchange would, bizarrely, be a favourable outcome for some or all of the surviving participants. Thomas Murray would prefer leaving the possibility of equity exchange open, with the award granted through a public tender mechanism run by the resolution authority only once calm has been restored to the market. If taxpayer funds are on the line due to implicit backing of the CCP and its members by the state, together with all the other costs to be borne by the government during resolution, the award of remaining assets to relaunch private-sector clearing should be made only after a public review in terms of best price, and a sufficiently deep knowledge of high-volume, risk management operations to sustain a robust institution.

The text might appear to assure a quick hand-off of these assets, which in some respects would be a good outcome in terms of continuity at a bad moment – but perhaps that is stated a bit too quickly. A prudent interval of clearing conducted under the auspices of the resolution authority might be the better result over the medium-term, and infrastructure is indeed about assuring that sense of permanence for the marketplace.

The quick, over-the-weekend hand-off of significant financial assets by the US authorities in the autumn of 2008 at prices that were questionable was not a spectacle that this firm would wish to see repeated there or elsewhere.

Questions 20-24 - Cross-border cooperation and effectiveness

The process of determining cross-border authorities seems well stated in terms of the lead given to the home jurisdiction, and other authorities brought to the table based on the materiality of contracts struck in those markets. It would be helpful if the composition of the CMGs would be communicated, perhaps quarterly, as part of the public posture the resolution authority should maintain. It is understood that some flexibility would need to be retained as to the composition of such bodies and their use of outsiders, but at least some selection criteria for the types of additional expertise that may be required should be set out in those communications.

Testing by the authorities of their coordination would be a very good idea, especially if the results and conclusions were published.

The idea of coordinated suspension of mandatory central clearing might be useful for relieving stress during recovery rather than during resolution. As stated previously, Thomas Murray believes that once a CCP is being resolved, the authorities should be fully in charge and continuous clearing services assured. Resolution would truly be the wrong moment for suspending operations.

Thomas Murray underscores the importance of CCPs having cross-border contractual, operational, and organisational arrangements, including interoperating CCPs and cross-margining practices. These would create complexities that could impede resolution, as written. In the past, several capital markets authorities pressed CCPs to open their risk books to inter-operability as a supposed prompt to competition; now in this Note, the FSB underscores the complications this introduces. There were competing policy objectives here, and prudent risk management came in second place to allegedly 'fair competition.'

It is imperative that the resolution authority set out policies that would be workable for the markets concerned, to the degree of detail possible.

Conclusion

The CCPs contacted by Thomas Murray believe they have solid recovery plans in place, given the sort of very worrisome foreseeable scenarios coming together as the basis for stress testing. That is truly all that can be asked of these institutions. Further, the measures already taken to shore up CCPs since 2009 have

been costly for the clearers and their clients, though necessary for meeting the demands of taking OTC contracts on the books. If, even after all this preparation, measures to recover a clearinghouse in difficulty fail, the resolution authority must be immediately ready and able to assure continuity of clearing.

The FSB is to be commended for taking these first steps in airing these questions. It is most helpful that the title to the Note refers only to resolution. We reiterate that the FSB and national authorities would do well to drop usage of the mixed term of "recovery and resolution," in order to specify on which side of the recovery /resolution question one finds oneself. The clarification of roles under each regime must first be distinguished and then detailed - separately.

To the extent possible, resolution of a CCP should be handled in a manner analogous to corporate bankruptcy proceedings, and the precedents established by resolution of other financial institutions – with the caveat that marketplaces usually have multiple banks or brokerages or insurance companies, but most of the time only a single clearinghouse. There would not easily be a hand-off of the clearing function other than to the resolution authority itself, and without clearing all trading would come to a halt.

Moral hazard cannot be eliminated. Its effects must be minimised, however; a balance will have to be struck by the resolution authority between showing enough in the way of guidance so that there will be assurances of business continuity whilst not underwriting unduly risky behaviour on the part of market participants. No one would expect such choices to be easy.

Thomas Murray's view is that more explicit guidance on how the authorities would proceed on resolution needs to be given now for the CCPs and their stakeholders to define their own resolution planning in greater detail, so that it responds to and fits that public planning. The authorities need to be leading this work; they would be leading in resolution, too.

We remain respectfully yours for questions you may have,

Sincerely,

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