



*Provider of Global
Capital Market & Cash Data*

Financial Stability Board

Guidance on Central Counterparty Resolution and Resolution Planning

Consultative Document issued on 1 February 2017

Return to fsb@fsb.org



Secretariat
Financial Stability Board
c/o BIS
Centralbahnplatz 2
CH-4052 Basel
Switzerland
fsb@fsb.org

Permission granted for public posting on FSB website

9 March 2017

Dear Sir or Madam,

The firm of Thomas Murray wishes to thank the Financial Stability Board for the opportunity to comment on “Guidance on Central Counterparty Resolution and Resolution Planning,” its further Consultative Document on this CCP question, issued on 1 February 2017.

Our remarks carry forward the spirit of what was submitted in response to the August 2016 discussion note on CCP resolution, and focuses it on these ten subject areas.

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 policy objective step-by-step. Our essential concerns were related to continuing market activity; and, on behalf of general clearing member clients, monitoring what their evolving liabilities might be. *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 also by falling liquidity and shrinking collateral pools due to other regulatory changes in the financial system. A significant drop in liquidity indicates ill health of a capital market.

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 from the two parties contracting to a more public venue.

The firm

The sole subject matter of this company is the analysis of the operations of the world's post-trade capital market infrastructures and related asset custody services. 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, the ownership and business purpose 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. 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, payment systems, 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

As with the August 2016 market consultation, there are passages in the current text 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. Thomas Murray would recommend ending the usage of “recovery and resolution” as a single term. The two subjects need to be distinguished at every level, including language usage.

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 and irreversible. It would be an extraordinarily difficult decision to take. Fundamentally, up to that very last moment, the point where the resolution authority declares that the CCP cannot be recovered, it should be led by clearing house management while reporting to its usual authorities. It must maintain its front-line operational authority.

As matters stand, the world's financial system has been guided by public authorities to a point where it is terribly dependent on the continued operation of half a dozen very large clearing houses for this singular, indispensable capital markets function.



Comments on the consultation's ten subject areas

1. We would restate the objective of this work: the key matter, in our view, is the continuity of public market operations, not financial stability for its own sake. Where there is a CCP in the midst of capital markets operations, its on-going functioning will by definition have become critical. It is on its way out of business at that point.

In the second sentence, there is, in our view, confusion between recovery and resolution. We understand resolution planning to be about how to maintain market operations after the decision has been taken that it is no longer possible to return to a matched book within the procedures laid out by, and resources available to, the CCP. The objective of resolution planning is the continuity of market activity during the wind-down of the infrastructure.

The document talks of “maintaining incentives” to centrally clear, but the day-to-day clearing of trades is less about incentive and more about market function and regulatory mandate. The operation of a CCP is an inseparable function of the markets for which it clears. The question that should be asked places the intangible in a physical environment, in order better to make the point: much like with machinery, how does one keep the market running whilst removing and replacing a vital cog?

2. We would add that the resolution authority should have all powers *when working in conjunction with the judiciary*.

The firm is of the belief that the resolution authority should not have the power to put the CCP into resolution prior to the CCP exhausting its procedures and resources related to its default management process. The resolution authority should be party to all decisions made and actions taken by the CCP, but if the CCP still has resources available to it, be they pre-funded or a legal commitment from clearing members under the rules of the CCP, then by definition the CCP is in recovery and not resolution. It should therefore be able to execute its default management process as planned.

Point 2.3 again returns the matter to the matched book question. In our minds, that possibility would no longer exist. Resolution authorities must accept that the point of no return will have been passed. It is the extremity of the decision that should focus all parties' attention on the need to avoid getting into that position.

This firm believes that tear-ups lead to market imbalance – suddenly, contracting parties find their positions out of line. We believe this would prove extraordinarily unsettling at what would be a very bad moment, sending parties scrambling to find cover or go into new position exposures. There is also an element of arbitrariness in choosing which contracts to tear up, the longstanding example being the cancellation of regulated exchange orders after an extraordinary event, “fat finger” or equivalent – which are to be kept and which are to be nullified, and the same extends to the options, futures and ETF products derived from those trades during those few minutes.

A further complication with tear-ups is whether OTC is considered to be transacted on a private market or a semi-public market, some elements of which are now shown publicly. Running OTC trades through central clearing created problems on multiple levels, and the possibility of being subject to having one's contract torn up after having been concluded in a private or semi-private market adds to the sense of arbitrariness.

Concerning point 2.15, the liquidation of a market infrastructure should, insofar as possible, resemble the liquidation of any corporation. Thomas Murray understands the necessity of writing down equity and creditor positions, but would still need persuading on the matter of the "awarding" of new instruments of ownership. That seems odd, as if recapitalisation were to have something to do with liquidation. Recapitalisation sounds as though the failing CCP is to be restarted. Equally, it would be odd if the customers of the CCP, the clearing members, would be asked to cover the failings of the clearing house – that simply does not take place in business.

As to eventual claims on the parent company's assets, Thomas Murray would see why clearing members would find this a tempting alternative. But we have also understood that one of the policy aims of the CPMI-IOSCO Principles from 2012 has been to ensure that market infrastructures operate well on a stand-alone basis, that a failure in one of them should not drag down the functioning of any other. That prior policy aim, which this firm supported in commentary submitted in 2011, would not appear to fit this newer point.

3. The decision to put a CCP into liquidation can only be taken by the resolution authority. Thomas Murray agrees. In this FSB document, the indicators listed that would lead to this judgment appear logical and exhaustive.

Under point 3.4, we do not believe a resolution authority can or should try to get "committed financial resources" beyond what was already established in the CCP's default waterfall and rulebook, if that is what this point is saying..

4. On allocating losses, under 4.3 the FSB paper raises the possibility of recapitalising the CCP, presumably for further central clearing. It seems contradictory to recapitalise a structure that is meant to be closing down. The other possible way of reading this text would be that the resolution authority is bringing in an entirely new owner interested in committing new capital as the CCP exits bankruptcy.
5. We appreciate the objective of the no creditor worse off safeguard. Our comment is that counterfactual arguments about what might have been the pay-off under the CCP's liquidation rules compared with what the resolution authority later had to determine sounds like an invitation to endless litigation. More simply, clearing participants have to assume that changes in regulatory risk are real enough, a cost of doing business even during liquidation. While we understand the purpose of this clause, counterfactual calculations sound like a worse outcome.



6. Financial resources for resolution are the heart of the problem. If resources were adequate for recovery, we would not find ourselves asking this question. The CCP should not be placed in resolution whilst it still has the resources to attempt to rebalance its positions.

Thomas Murray understands the aim of avoiding the public purse. The one intermediate step that might be worth exploring is having the institutional investors using exchange-traded derivatives and OTC contracts, the contracting parties, get more involved in risk management and be made to understand that in extreme circumstances some of their resources might be on the line. This new liability would create quite a shock, we do realise. It is our understanding, too, that central bank users of OTC contacts do not have to provide margin – maybe the provision of public resources in this sense, as required of private parties on an equal basis, could be used to increase the assets available to a CCP for current, ongoing operations, thereby reducing the risk in the first place. At any rate, these two ideas might be explored before recourse to outright public ownership of a CCP.

As to temporary public ownership, our note of caution is that “temporary” can last a very long time, and still be very expensive for the taxpayer. We strongly concur with the wording about credible and effective enforcement mechanisms and sufficient transparency must be provided in advance as to how this new entity would operate.

7. Resolution planning as stated in the grey area is correct. We agree that it is important that resolution plans covering different scenarios are developed, especially for scenarios that are not caused by a clearing member default and would in fact be due to clearinghouse management errors. We would add that the authorities need to lead on this plan, and that the agreed plan should be made public, largely if not in its entirety. It should be sufficiently transparent and daunting so that the incentive of the plan supports rigorous risk management by the CCP beforehand.

Point 7.2 again blurs the line between recovery and resolution. The recovery plan of the CCP will primarily be the default management procedure, recovering to a matched, risk-neutral book. The resolution plan, or at least the plan related to a clearing member default scenario, should concern the period after the default management procedure and the associated resources have been exhausted, and it has been determined by both the CCP and the resolution authority that the CCP will not be able to return to a matched book. 7.3 further blurs the lines; if part of the plan is to replenish the financial resources of the CCP then this should surely be deemed as recovery. As worrying as it may be, authorities need to be clear that resolution means resolution, the end of the CCP as we know it and move to a different market function, at least temporarily.

8. This firm supports periodic assessments as to the adequacy of resolution planning, perhaps in conjunction with stress testing. The markets do evolve, and the plans must be adapted accordingly.

On this matter as on this entire subject, the resolution authorities must at all times act co-operatively with the management of the CCP. As a practical matter, there is a great dependency on the expertise of those managers, like it or not.



9. Concerning multi-jurisdiction crisis management groups, this firm believes there is already good co-ordination amongst capital markets authorities on the topic of market infrastructures. We agree that this co-ordination on the matter of liquidation needs to be formalised. We would suggest that the resolution authorities take it as a given that the failure of an entire CCP would immediately have questions of interconnectedness, given cross membership of general clearing members, as well as the dispersal of assets.

Thomas Murray would also suggest that the Crisis Management Group of several resolution authorities immediately set up a corresponding group of concerned private sector clearing participants. There is a good historical record of collaborating on liquidation of defaulting clearing member assets, though nothing yet on a par with the potential fall-out of an entire CCP having to be closed down. It is nonetheless hard to see how private sector involvement in planning and execution would be a bad thing.

10. The effectiveness and enforceability of a CCP's cross-border contractual arrangements should be showing up clearly in its disclosure of its level of observance of the CPMI-IOSCO PFMI. This point is central in the context of on-going operations, let alone in liquidation.

In this firm's collaboration with FMIs on these Principles, we have often found weaknesses in Principle 1 on the legal bases of the infrastructure. Laws are either out of date, which is understandable given the modified positions of infrastructures post-2007 / 2009, and also that there is a lack of jurisdiction backing up the enforceability point. Much of what is new on paper has simply not been tested in the courts.

Conclusion

Since 2009, global policy makers have put the capital markets in a progressively more awkward cul-de-sac by trying to accommodate the risk inherent in banks' OTC derivatives contracts in the environment of clearing regulated, public market contracts. This "solution" to the counterparty problem never seemed likely to succeed, in this firm's view, no matter how and how much clearing house operations were to be tightened. The BIS statistics¹ underscore the point that the remaining risk to the market remains essentially as high as in 2008 anyway, though it has likely that this has been largely passed off to other actors.

The goal now should be to back at least some of the way out of this policy impasse. The only definitive way we can imagine is to make bilateral contracting parties responsible for the risks they choose to run,

¹ "Derivatives market is short of a \$ 3.7 tn lifeboat." Central clearing has not proved a magic solution for systemic risk, according to a [Financial Times](#) opinion published on 10 February 2017. We note that the BIS definition is netted position excluding collateral, which for some reason is not counted. If it were to be counted, the exposure would be lower, but by an amount we do not believe anyone actually knows.



and to have them stop passing off the risk and cost to other actors while keeping the contract arrangement fees.

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 truly is all that can be asked of these institutions.

If measures to recover a clearinghouse in difficulty fail, the resolution authority must be known to the market to be immediately ready and able to assure continuity of clearing. That reassurance alone would provide a modicum of stability, though no one should ever be in doubt of the psychological impact of declaring an entire clearing house to be in liquidation. We reiterate the matter at hand: this is about the failure and liquidation of an entire market infrastructure, which is a question orders of magnitude more significant to the market than the problem of a single general clearing member being in default. The term “resolution” sounds too comfortable for the hard reality.

To the extent possible, resolution of a CCP should be handled in a manner analogous to corporate bankruptcy proceedings, and the precedents established by the liquidation 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 the clearing function all trading would come to a halt. Any stoppage in post-trade servicing stops the market.

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. This is not easy, largely because the question being asked of clearing houses has been in good part wrong: the handing off of OTC counterparty risk into the public market domain causes many knock-on problems.

CCP resolution planning must respond to and fit a public need of the highest order. The authorities need to be leading this planning work; they would find themselves leading in resolution, too.

We remain respectfully yours for questions you may have,

Sincerely,

Thomas Krantz

Senior Advisor Capital Markets

Alex Harborne

Senior Analyst

CC: Simon Thomas, Jim Micklethwaite, Janet Wynn, Tim Reucroft, and Ana Giraldo, TM