Comment: FSB Report on Central Counterparty Financial Resources for Recovery and Resolution – April 29th, 2022

Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 250 market-infrastructures, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%). with everything from local entities in emerging markets to groups based in major financial centres. Collectively, member exchanges are home to nearly 53,000 listed companies, and the market capitalisation of these entities is over $95 trillion, while the 50 distinct CCP clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up $1 trillion of resources to back their risk positions.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise financial stability, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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WFE comment on the Financial Stability Board's report on Central Counterparty Financial Resources for Recovery and Resolution

April 2022

The WFE appreciates the opportunity to comment on the FSB report on Central Counterparty Financial Resources for Recovery and Resolution (the **Report**) to share perspectives and feedback on behalf of our members. We remain supportive of the broader effort to ensure that the international policy framework best promotes the resilience, recoverability, and resolvability of CCPs in default and non-default loss scenarios.

The WFE has previously publicly expressed support for initiatives that enhance the risk framework for clearing and prioritise financial stability, whether led by CPMI-IOSCO, the FSB or jurisdictional regulatory agencies, and has sought to proactively contribute to the international debate on these issues and others. In doing so, its members have contributed significantly to the further strengthening of the system through engagement with stakeholders on the implementation of many post-crisis initiatives.

The WFE and its members share the FSB's goals of ensuring the safety and soundness of the global financial system, which is critical to enhancing investor and consumer confidence, and promoting economic growth. In that context, WFE appreciates the opportunity to comment on this Report.

EXECUTIVE SUMMARY

The WFE welcomes this Report and associated analysis by the FSB (and global standard setting bodies) to assess and consider where further work to support financial stability may be justified. Whilst the scenarios in which a CCP would need to be recovered let alone resolved are both extreme and remote, the work done by local authorities in preparation gives a degree of clarity to stakeholders concerned with managing their risk.

We appreciate the analysis and assessment performed by the global standard setting bodies described within the Report. Upon review of the analysis results, we believe that the Report confirms the resilience of CCPs to beyond extreme market scenarios and events and thus no further guidance on CCP resources in resolution or otherwise is necessary.

Our comments are organised into two parts, the first shares our feedback on the Report and the second shares our feedback on the potential impact to CCP risk management.

I. Feedback on the Report

Evidence-gathering and Analysis

The Report states that an 'evidence-gathering and analysis' exercise was intentionally structured to apply market scenarios and events that are **both extreme and implausible** (as acknowledged in the discussion on limitations and assumptions), thereby going beyond the current international policy framework standards established for CCP risk management, recovery, and resolution. To be clear, these standards expect that a CCP maintain resources to address extreme but plausible market conditions and to have additional tools and/or resources to address losses that may arise in recovery. **While we believe this is an informative sensitivity analysis and reverse stress testing exercise, we believe it is inappropriate to base decisions on whether to implement further international policy on findings that are intentionally designed to exceed current risk standards and what it is reasonable to prepare for**.

Notwithstanding this, as described below, despite the extreme and implausible nature of the scenarios assessed, CCPs proved resilient. And this is despite the fact that the Report generally failed to recognise that CCPs' resources and default management measures/tools for recovery cannot be looked at in a vacuum from their other risk management practices that greatly mitigate the likelihood of an event giving rise to (even) a recovery event in the first place. We believe this is only further demonstrated by the resiliency of CCPs in managing and navigating recent market stress events.

<u>Regarding the analysis within the Report, we have the following observations</u>:

Default Losses

- The market scenarios and events included in the scenario analysis of default losses for CCPs were not just extreme but implausible, which makes it questionable why further work would be necessary, especially given the predominantly successful performance of CCPs in navigating even these scenarios. Implausible scenarios should not in our view be the basis for further work on CCP resources. Further, the highly unlikely nature of a resolution event suggests that regulators should apply a careful risk-reward analysis when deciding approaches to financial resources.

- The Report is transparent in that the default loss scenarios applied were "intended to be significantly more severe than the 'extreme but plausible' standard set out in the PFMI" (pg. 5). However, it fails to provide sufficient justification on the reasoning to include such scenarios and instead sets an arbitrary new level for resources – for example, applying a 1.4 multiplier and assuming the default of the four largest clearing member groups. Moreover, despite such implausibility, the Report notes that "the sample CCPs would have had sufficient prefunded and recovery resources and tools to cover losses in the applied default loss scenarios" (pg. 20).

  It is worth highlighting the Report's findings that seven of the 15 CCP service lines were able to fully address the potential losses with only their prefunded financial resources. And of the eight CCP service lines that used measures beyond the mutualised default fund, six were able to address such losses by utilising their recovery cash calls. The findings also note that, for the one CCP that had to employ VMGH (following cash calls), the analysis "identified only limited impacts on their liquidity and solvency from the use" (pg. 3) of such measure at the bank clearing member level. The findings also note that no CCP had to use resolution cash calls or its required capital in the scenario applied.

- We also note that in such extreme circumstances, there would also be actions taken by the CCP and the clearing participants as well as by supervisory/regulatory authorities to address any such market scenario and/or event that would need to be contemplated by resolution authorities in connection with any actions to be taken and this was not factored into the analysis.

  Against this background, it is an even more positive outcome that the CCPs showed such strong resilience to default losses, confirming our view that CCPs' default loss resources and default management measures/tools for recovery and resolution are sufficient. Therefore, by virtue of their own prudence, CCPs are very well equipped to navigate even extreme and implausible market scenarios and events.

Non-Default Losses (NDL)

- The Report characterizes the NDL scenarios as "common scenarios which were considered to be sufficiently severe", however, as described below, we respectfully disagree with this characterisation, not least because it largely ignores risk-management practices that CCPs employ to mitigate (eg, cyber security, counterparty risk management, settlement controls) and address (eg, legal and regulatory protections) such scenarios if they were to occur. We believe that it should be recognised that non-default related risks are capable of being managed, not only in terms of mitigating financial impact but also by reducing the likelihood of occurrence in the first place.

- While the Report notes that such scenarios are not 'grounded in actual experience', we believe it should clearly recognise that such scenarios are beyond extreme and implausible and that it should also account for actions that would be taken by regulators, the CCP, and/or the clearing members, many of which are already accounted for in existing regulatory frameworks and the rules/procedures of the CCP.

- For example, the NDL scenarios implausibly assume that the resolution regime for financial institutions (including that for global systemically important banks) has not been successful or has completely failed, which is troubling, as one of the key objectives of policymakers' work following the Great Financial Crisis of 2008 was to provide continuity of banks critical services. Further, the analysis is without due consideration to the FSB guidance on Continuity of Access to FMIs for a Firm in Resolution. Additionally, the specific NDL scenarios are implausible for several reasons, including:

- **NDL Scenario 1**: While the assumptions of the first NDL scenario are unlikely to occur in the first place (notably because of the resolution regimes for banks), it implausibly assumes that the following events could all occur simultaneously: i) a CCP loses access to the institution holding assets on behalf of the CCP that would cause the largest liquidity need to the CCP and the institution's affiliated clearing members default; ii) the two clearing members generating the largest payment obligation also default; and iii) funds deposited to a settlement bank also become inaccessible mid-settlement cycle. Not only is the likelihood of these occurring at once implausible in itself but, as noted above assumptions i) and iii) do not fairly recognize the resolution regime that is in place for banks and additionally, with respect to iii), this assumption does not recognise the narrow timeframe in which funds are typically moved during a settlement cycle.

- **NDL Scenario 2**: The assumptions of the second NDL scenario implausibly assume that cash equalling the largest total sum amount transferred on any day to a single depository was subject to cyber theft. Depending on a CCP's risk management practices for collateral, this would require an assumption that multiple transfers throughout the day are subject to theft. However, if a CCP were to identify an issue earlier in the day with a given bank, such as a theft of funds, it would take proactive measures (eg, to not continue using such bank). Nor does the second NDL scenario adequately consider a CCP's risk management practices for collateral that already mitigate the likelihood of this scenario occurring. These would include, as example, cyber security protocols, account set-up and use controls (eg, account agreements and distinct individuals performing set-up and approval functions), automation controls (eg, SWIFT design), and daily settlement operations controls.

It is worth highlighting the Report's findings that, despite the implausibility of the first NDL scenario, all CCPs were able to address the liquidity needs without the complicating assumptions and that notwithstanding the even more implausible complicating assumptions, all but one CCP had sufficient liquid resources (inclusive of arrangements to meet liquidity needs). Furthermore, even with respect to the second NDL scenario, two CCPs' prefunded and recovery resources were sufficient to address the scenario. Against this background, it is an even more positive outcome that the CCPs showed such strong resilience to non-default related risks by virtue of their own prudence and existing risk management practices and measures/tools for recovery and resolution.

- We agree that there are limitations to the analysis as acknowledged in the Report. In particular, we agree that the most significant limitation of the NDL analysis was that the results greatly depend on the 'choice of scenarios' and related assumptions. Therefore, we believe that the results (ie, that only through the use of resolution tools would sufficient resources have been mobilised) should be interpreted with caution.

Financial Stability Implications

The Report states that a quantitative assessment of financial stability implications was performed to assess the potential impact of the use of two recovery and resolution tools – cash calls and VMGH – on the liquidity and solvency of clearing members in stressed market conditions. We believe that the need for further work is not supported, given the favourable outcomes of the assessment.

It is worth highlighting that the Report's findings concluded that "… the use of cash calls and VMGH appear to have a notably less than significant impact on bank clearing members' liquidity in comparison to their starting liquidity positions. Similarly, the impact of the use of cash calls and VMGH on bank clearing members' solvency was limited compared to their starting solvency position" (pg. 6), which was even the case even when assuming maximum cash calls, 100% VMGH and large haircuts to HQLA. The qualitative review within the Report found that both cash calls and VMGH had low performance risk and therefore are expected to be reliable, therefore we query a conclusion that further work is needed.

Nevertheless, given that there is observed differences on the impact across clearing members for these measures, it would be beneficial for any further analysis to assess and share normalized variance (or standard deviation) of the impact of cash calls and VMGH within each group. Such data would allow CCPs, in collaboration with their regulator and resolution authority, to better understand the impacts of such measures to an individual CCP. The Report also notes that VMGH and (partial) tear-ups were assessed in 'conjunction'. However, it is not clear what assumptions and/or impact was assessed (particularly given that these are two types of measures/tools that may or may not be applied in sequence).

Regarding the conclusions of the Report, we have the following comments:

We appreciate the work of international policymakers to develop standards that support the stability of the broader financial system. As we have described, we believe that the Report demonstrates the robustness of the current risk framework for CCPs to maintain resiliency through extreme market events and scenarios (and that is before any of the actions that would be taken by the CCP as part of their broader risk framework) – and that this is only further affirmed by the findings concluded throughout the Report.

We believe that the Report does not recognise the dynamic nature of CCP risk management, occurrence of market scenarios and events, or implementation of recovery and resolution measures. CCP risk management is dynamic, purposefully reactive to potential market scenarios and events, and often complementary – for example, in the context of financial resources, actions that are taken by the CCP are intentionally structured to reduce exposures to such financial resources.

II. Impact on CCP Risk Management

CCPs have carefully designed their risk management frameworks, including the financial resources that make up its default waterfall, to support incentives for market participants to effectively manage their risks, as has been demonstrated historically and in response to recent unprecedented market stress and events. In this context, therefore, it is important to recognise that CCPs' financial resources for recovery and resolution cannot be looked at in isolation from its fundamental risk-management practices, which greatly mitigate the likelihood of any market scenario or event leading to recovery measures in the first place.

As a principal matter, the viability of a clearing service is not based only on the quantum of financial resources available in the event of a default(s) or other loss scenarios; rather, and more significantly, the ability for the CCP to successfully apply default-management procedures (including those that may be part of recovery measures agreed ex-ante with its clearing members) and other risk-management practices that have been carefully calibrated to create risk-management incentives for a CCP's participants, thereby reducing potential reliance on, and exposure to, available financial resources.

Because the analysis in the Report does not appear to consider the significant impact that such risk-management practices (including default management procedures) would have in default loss and NDL scenarios, we feel that the Report overlooks one of the most fundamental functions of a CCP. If the analysis had considered these actions and the incentives inherent in the centrally cleared model, particularly with respect to default losses, we believe it would only further negate the need for any further work. We caution any new policy that could result in inappropriate changes to loss bearing that could have the consequence of undermining risk management incentives in place at CCPs.

Financial Resources for Recovery and Resolution

The Report states that further analysis will be performed on financial resources for recovery and resolution, specifically resources or measures as part of the 'toolkit' for any such scenarios. Following on from our above comments, we consider that any undue emphasis on mechanisms to compensate stakeholders in a CCP resolution scenario (either ex-ante or as part of actual resolution) risks undermining the incentives that exist to support the default-management process and recovery of that CCP. Such a result risks introducing new moral hazard in the recovery process and *increases* the likelihood that public intervention would be required.

As the resolution of a CCP would be a highly disruptive extreme tail event; the recovery of a CCP is a far preferable outcome for all concerned. The resilience practices and recovery plans that CCPs have adopted in the post-crisis era have been carefully designed in close co-ordination with a CCP's local regulatory authorities in consideration of applicable international standards.

Any consideration for new international policy should be mindful of the potential impacts on a CCP's risk-management and recovery tools and be designed to ensure that it does not reduce the likelihood of successful CCP-led recovery. Any regime that provides incentives for clearing members (or other stakeholders) to see the CCP resolved rather than recover would be antithetical to supporting the stability of the broader financial system and inconsistent with the PFMIs.

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