INVESTMENT COMPANY INSTITUTE

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July 13, 2020

FSB Consultation on CCP Resolution: Member Input Requested by Tuesday 21 July

[32597]

July 13, 2020 TO: Derivatives Markets Advisory Committee
Global Advocacy Coordination Advisory Committee
ICI Global Regulated Funds Committee
ICI Global Trading & Markets Committee RE: FSB Consultation on CCP Resolution: Member Input Requested by Tuesday 21 July

On 4 May 2020, the Financial Stability Board (FSB) published a consultative document ("the consultation") on proposed guidance for financial resources to support central counterparty (CCP) resolution and the treatment of CCP equity in resolution.[1] ICI Global plans to submit comments to the FSB by the 31 July 2020 deadline. If you would like ICI Global to include particular comments or concerns in its response, please contact me at giles.swan@ici.org by Tuesday 21 July. ICI Global's draft response will be discussed at the next meeting of the Derivatives Market Advisory Committee on 23 July 2020.

Background

The consultation is part of the FSB's implementation of the post global financial crisis G20 commitments to reform OTC derivative markets. It builds on prior FSB work on key attributes of effective resolution for financial institutions,[2] including financial market infrastructures (FMIs),[3] CCP resolution and resolution planning[4] and guidance on continuity of access to FMIs.[5] It also supports the principles for FMIs (PFMIs) developed by CPMI-IOSCO.[6]

On 15 November 2018, the FSB published a discussion paper on financial resources to support CCP resolution and the treatment of CCP equity in resolution ("FSB 2018 Discussion Paper")[7] to which ICI Global responded.[8] In the consultation, the FSB has developed the draft guidance in its 2018 discussion paper, taking into account public and private sector input it received.

Consultative Document

The FSB is consulting on draft guidance to support authorities and crisis management groups (CMGs) covering the following:

- Assessing the adequacy of financial resources needed to absorb losses and to cover other costs in CCP resolution; and
- Developing approaches to the treatment of CCP equity in resolution.

The questions raised in the consultation by the FSB are summarised in the annex to this memo and outlined in more detail below.

In the preamble to the consultation, the FSB notes that in order for a CCP to be successfully resolved there must be adequate financial resources and tools to support the CCP's orderly resolution and to minimise adverse effects on financial stability. The FSB recommends that as part of resolution planning, resolution authorities should assess the adequacy of existing resources and tools, including their availability at the point of resolution and any adverse effect that their use will have on financial stability in various resolution scenarios. The FSB's guidance is intended to support jurisdictions in determining whether there is a gap in the resources and tools available for resolution and how such a gap can be addressed. The FSB envisages that the assessment for systematically important CCPs should be reviewed and updated on an annual basis.

Assessing the adequacy of financial resources to support CCP resolution

The FSB's prior guidance[9] recommends the development of CCP resolution plans that address default and non-default loss scenarios and a combination of both. In the consultation, the FSB has developed the five-step process it proposed in its 2018 discussion paper, as outlined below.

1. *Identifying hypothetical default and non-default loss scenarios (and a combination of them) that may lead to resolution.*

The FSB recommends that relevant authorities[10] consider a reasonable range of default loss scenarios and non-default loss scenarios in resolution planning, including those occurring in market conditions that are beyond "extreme but plausible".

The FSB proposes that authorities should consider at least the following the hypothetical default loss scenarios:

- The CCP does not have sufficient resources and tools for a successful recovery as called for by the PFMI;[11]
- The CCP's loss allocation arrangements set out in the recovery plan do not operate as intended;
- Multiple clearing members do not meet their obligations under the CCP's recovery actions;
- The relevant authorities determine that resolution should be initiated before some of the arrangements or tools under the CCP's recovery plan are applied.

The FSB proposes that authorities should consider at least the following hypothetical non-default loss risks:

- Investment risks;
- Failure of a custodian, depository, a payment or settlement bank, a securities

settlement system or other entity providing similar services;

- Operational risk events;
- Legal risks.

Having considered the non-default loss risks above, the FSB proposes that authorities should consider at least the following hypothetical non-default loss scenarios:

- The CCP does not have sufficient financial resources or tools to cover non-default losses;
- The CCP's arrangements to cover (specific) non-default losses set out in the recovery plan cannot be used or do not operate as intended;
- The CCP's clearing members do not meet their obligations under the CCP's recovery actions;
- The CCP's shareholders do not support the CCP's recovery actions;
- The relevant authorities determine that resolution should be initiated before some of the recovery arrangements or tools are applied or the CCP is wound down.

In the consultation, the FSB asks the following questions:

Q1: What are your views on the scenarios presented for evaluating existing tools and resources?
Q2: Are there additional considerations that should be included in the guidance?

2. *Conducting a qualitative and quantitative evaluation of existing resources and tools available in resolution.*

The FSB proposes that resolution authorities should conduct a qualitative and quantitative evaluation of the CCP's existing financial resources and tools under the scenarios identified above, including the following:

- The availability of existing resources, including resources available to cover relevant costs;
- The ability to rely on particular tools to create resources; and
- The potential that the use of these resources or tools would have an adverse effect on financial stability.

The FSB proposes several key points that authorities should consider for the qualitative evaluation of existing tools and resources[12] and the following considerations for quantitative analysis:

- Differentiating the amount of resources available for resolution according to the nature of the underlying resources and tools (e.g. prefunded, committed or uncommitted);
- Developing metrics for fully reorganising or discounting different types of resources based on the level of confidence about whether they are likely to be available in a comprehensive and timely manner; and
- Coordinating with the oversight and/or supervisory authorities of clearing members,

notably in the context of assessing the potential performance risk and/or financial stability implications of enforcing certain recovery and resolution tools.

The FSB proposes several additional points for non-default and default loss scenarios that should be considered by authorities, including those in the table below.

Default Loss Scenarios

Non-Default Loss Scenarios

Cash Calls

Insurance coverage and other third-party resources supporting operational continuity.

Replenishment of minimum resources

Allocation of losses to clearing members

Variation margin gains haircutting (VMGH)

Allocation of losses to creditors in resolution

CCP equity and other financial resources from the CCP or its affiliates

Statutory powers of the resolution authority

Full tear up, partial tear up or other position allocation/matched book tools

In the consultation, the FSB asks the following questions:

Q3: Are the qualitative and quantitative considerations for evaluating existing resources and tools comprehensive and sufficiently clear?

Q4: Are there additional considerations that should be included in the evaluation?

3. *Assessing potential resolution costs*

The FSB proposes that the resolution authority will conduct a qualitative and quantitative assessment of the different types of costs that could arise in the resolution of a CCP in the various scenarios identified in step 1, including: (i) the potential amount of the CCP's losses and the costs of replenishing its financial resources; (ii) operational costs of the CCP; and (iii) the administrative costs of the resolution authority. The FSB suggests that the following potential resolution costs are considered by resolution authorities:

- The size of resolution costs associated with the potential resolution strategy or strategies;
- The time frame when resolution costs need to be met in the short and longer term; and
- Who will bear the different types of costs, how the costs not fully covered by use of resolution tools may ultimately be recoverable, and from whom?

For non-default losses, the FSB recommends that resolution authorities should consider all relevant scenarios and factors including: (i) investment losses; (ii) losses due to the failure of a custodian, depository or payment bank; (iii) operational risk events; and (iv) legal risks.

The FSB notes that resolution costs may last for several weeks or months and there may be additional costs following resolution, including NCWOL[13] compensation.

In the consultation, the FSB asks the following questions:

Q5: Are the considerations for analysing resolution costs comprehensive and sufficiently clear?
Q6: Are there any other resolution costs that should be addressed?

4. *Comparing existing resources and tools to resolution costs and identifying any gaps.*

The FSB proposes that resolution authorities will take account of resolution scenarios in Step 1 to identify gaps between the costs identified in Step 3 and the resources and tools analysed in Step 2, by considering at least the following:

- The availability and sufficiency of existing resources and tools to cover the types of costs they are intended for, in a manner that mitigates the impact on financial stability;
- The availability and sufficiency of existing resources and tools to cover other types of costs, given the chosen resolution strategy and the degree to which resources may have been used in recovery;
- The types and amount of costs, if any, that are not covered by existing resources and tools;
- The time horizon for executing the resolution strategy and the manner for paying resolution costs, based on the estimates of the availability and sufficiency of resources and tools;
- The additional information or analysis that would be useful to determine any need for additional resources or tools;
- The types and amount of additional resources and tools, if any, that would be needed in the identified cases;
- The fact that, while some CCP liabilities may effectively be deferred or allocated to unsecured or unsecured creditors in resolution (for instance via write-downs), operational costs necessary to maintain the CCP’s critical functions must be paid in full; and
- The potential consequences if existing resources and tools are not adequate to achieve the resolution objectives across a range of resolution strategies, such as negative impacts on financial stability.

In the consultation, the FSB asks the following questions:

Q7: What are your views on the considerations for resolution authorities when they identify gaps in resources and tools?

Q8: Are there additional considerations that should be included in the guidance?

Q9: Are there any specific steps or approaches you would suggest that authorities consider as part of quantitative analyses?

5. *Evaluating the availability, costs and benefits of potential means for addressing any identified gaps.*

The FSB proposes that authorities should consider at least the following when evaluating shortfalls and gaps between existing resources and tools and resolution costs:

- whether additional tools or resources may be necessary to support resolution;
- what options exist for addressing any identified gaps;
- the costs, benefits and likely unintended consequences of each option;
- how to involve the relevant oversight and/or supervisory authorities to close the potential gaps;
- the financial stability implications of each option; and
- whether the resolution strategy could be adjusted to optimise the use of available financial resources, either as a standalone option to address any identified gap or in addition to requiring additional financial resources.

The FSB proposes that resolution authorities consider at least the following potential implications of requiring any additional resources or tools: (i) the nature of additional financial resources; (ii) additional cash calls; (iii) write-down/bail-in powers; (iv) interaction with recovery and business as usual impact on the CCP. Furthermore, the FSB proposes that when considering the steps to be taken to address gaps between existing resources and tools and resolution costs, authorities consider the following:

- to what extent additional resources and tools are necessary to cover the identified shortfall in financial resources available for resolution;
- to what extent the identified additional resources and tools could address liquidity needs in resolution;
- how to weigh any differences in the impact on financial stability of the alternative means of addressing any gaps; and
- whether any gaps could be addressed through changes to the CCP's rules or governance documents or changes to the applicable legal or regulatory regime.

In the consultation, the FSB asks the following questions:

Q10: What are your view on the considerations for evaluating the availability, costs and benefits of potential means to address identified credit or liquidity gaps?

Q11: Are there additional suggestions for potential steps to address identified credit or liquidity gaps that should be included in the guidance?

Treatment of CCP equity in resolution

The FSB notes that one of the objectives of an effective resolution regime is to provide a mechanism enabling shareholders and creditors of a CCP to absorb losses in a manner that respects the hierarchy of claims in liquidation. Furthermore, that CCP equity should: (i) absorb losses first; (ii) be fully loss-absorbing; and (iii) have the potential to be fully or partially written down by resolution authorities. The FSB notes that its key attributes of effective resolution include a NCWOL safeguard, assuming full application of the CCP's rules and procedures for loss allocation (i.e. where creditors receive at a minimum what they would have received in liquidation of the CCP). Furthermore, the PFMI developed by CPMI-IOSCO require a CCP to have in place comprehensive loss allocation arrangements for default losses which typically allocate the majority of losses to clearing members with predefined limits. Losses beyond these limits are often allocated to clearing members and in some cases clients through tools such as VMGH.

The FSB notes that very often only prefunded CCP equity dedicated to cover default losses as part of the default waterfall is exposed to default losses under the CCP's rules and any remaining losses are allocated to clearing members and other participants rather than CCP equity. Furthermore, the FSB notes that while CCP equity generally bears non-default losses, some CCPs have arrangements that allocate portions of non-default losses, particularly those arising from investment or custody risks, to clearing members rather than being covered by a CCP's own financial resources. The FSB suggests that such actions in resolution may result in CCP equity holders raising NCWOL claims, which in turn may be inconsistent with the principle that CCP equity should be fully loss absorbing in resolution and raise moral hazard claims.

The FSB proposes that when developing resolution plans and strategies, resolution authorities should fully understand for each default and non-default loss scenario and the combination of both:

- the treatment of equity under existing recovery arrangements, taking into account the ownership structure of the CCP;
- the extent to which equity would be exposed to losses in liquidation under the applicable insolvency regime, based on the relevant counterfactual; and
- the NCWOL safeguard, including the treatment of equity in liquidation.

The FSB proposes that when the resolution authority develops resolution plans and strategies, it should also consider at least the following:

- the point in time or the position in the default loss waterfall for equity to bear losses;
- potential challenges and constraints to CCP equity bearing losses in resolution in excess of the amounts contemplated by the CCP's rules or other contractual loss allocation arrangements; and
- any other factors that may affect its assessment of whether the treatment of CCP equity in resolution is appropriate and consistent with the FSB's prior guidance.

The FSB suggests that when evaluating the timing and sequencing of imposing losses on CCP equity beyond those provided under the CCP's rules and other contractual loss allocation arrangements, the resolution authority should consider at least the following:

- incentives for stakeholders, particularly clearing members, to support recovery;
- the need to maintain an appropriate balance between flexibility for the resolution authority and certainty and predictability for participants;

- implications for the application of the NCWOL safeguard;
- potential NCWOL claims by shareholders and assessment of any possible options to attenuate or solve any identified NCWOL obstacle;
- financial stability implications; and
- the law of the jurisdiction, including insolvency law, and the rules of the CCP and available powers to impose losses on equity in resolution.

In the consultation, the FSB asks the following questions:

Q12: Are the considerations for addressing the treatment of CCP equity in resolution plans sufficiently clear?

Q13: Are there additional factors that resolution authorities should consider when evaluating the exposure of CCP equity to losses in resolution?

Mechanisms for adjusting the treatment of CCP equity in resolution

The FSB proposes that resolution authorities should consider at least the following adjustment mechanisms for the treatment of CCP equity in resolution:

- Exposure of some or all of the CCP's equity to losses via modification of the contractual loss allocation arrangements;
- Full or partial write down of CCP equity;
- Transfer of critical CCP operations (assets and certain liabilities) to a bridge entity and placing the remnant CCP into liquidation/receivership;
- Dilution of existing ownership by raising new capital through conversion or issuance of new shares

Prior FSB guidance recommends that resolution authorities have the power to compensate clearing members that contribute financial resources to a resolution in excess of their obligations under the CCP's rules and arrangements, in both default and non-default loss scenarios. The FSB proposes that before exercising such power, the resolution authority should consider at least the following:

- whether it could compensate clearing members by providing shares in the CCP in return for any cash call or VMGH that is applied beyond the arrangements set out in the CCP's rules, and what the value of such compensation would be;
- whether issuing shares in the CCP in return for a (resolution) cash call or VMGH could pose legal or practical challenges to clearing members or indirectly to their clients; and
- how equity compensation would affect the allocation of any recoveries the CCP would make from the defaulter's estate.

The FSB also proposes that the resolution authority, in cooperation with the CCP's oversight and/or supervisory authorities, should evaluate whether it should require that the CCP's rules enables clearing members to claim reimbursements for excess contributions, including through additional haircuts or cash calls, which would result in them having a corresponding claim against the CCP that would rank ahead of equity.

In the consultation, the FSB asks the following question:

Q14: Are there additional mechanisms that could be used for adjusting the exposure of CCP equity to losses in resolution that should be included in the guidance?

Implementing policy for the treatment of CCP equity in resolution

The FSB proposes that based on the analysis undertaken in accordance with the above, resolution authorities may have the relevant powers to require that CCPs modify their capital structures, rules or other governance documents in a manner that subordinates shareholders to other creditors or sets out the point at which equity absorbs losses in legally enforceable terms. The FSB notes that changes to laws, regulations or powers of relevant supervisory oversight may be required and where the jurisdiction's framework restricts the authorities' powers then a statement in the resolvability assessment process should be included regarding any limitations. The FSB proposes that adjustments to ensure equity bears losses in resolution (particularly in default loss scenarios) would be appropriate in light of the following:

- Impact on CCP management incentives;
- Impact on stakeholder incentives to support recover and avoid resolution;
- Impact on clients;
- Impact on continuity of critical services following resolution;
- Impact on different business models and legal structures of CCPs.

In the consultation, the FSB asks the following questions:

Q15: Within the section on implementing policy for the treatment of CCP equity in resolution, are there additional items that the relevant home authorities should consider?

Q16: Would a statement in the resolvability assessment process on any limitations to equity bearing losses provide sufficient transparency for stakeholders? How could sufficient transparency be achieved?

Next Steps

The FSB intends to finalise its guidance, taking into account the input it receives to the consultation. Five years after the publication of the final guidance, it will consultation with the Committee on Payments and Market Infrastructures (CPMI) and IOSCO to determine whether further adjustments are needed to the guidance, in light of market developments and resolution authorities' experience with using the guidance.

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Attachment

endnotes

[1] Consultative document: Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution, Financial Stability Board, 4 May 2020, *available from* https://www.fsb.org/wp-content/uploads/P020520.pdf

[2] Key attributes of effective resolution regimes for financial institutions, Financial Stability Board, October 2014, "FSB Key Attributes", *available from* www.fsb.org/2014/10/r_141015/

[3] Appendix II-Annex 1, FSB Key Attributes

[4] Guidance on Central Counterparty Resolution and Resolution Planning, Financial Stability Board, 5 July 2017, ("FSB 2017 Guidance"), *available at* http://www.fsb.org/wp-content/uploads/P050717-1.pdf

[5] Guidance on continuity of access to financial market infrastructures for a firm in resolution, Financial Stability Board, July 2017, *available from* https://www.fsb.org/2017/07/guidance-on-continuity-of-access-to-financial-market-infrastructures-fmis-for-a-firm-in-resolution-2/

[6] Principles for financial market infrastructures, CPMI-IOSCO, April 2012, *available at* https://www.bis.org/cpmi/publ/d101a.pdf

[7] *See* Memorandum No. 31516, RE: Financial Stability Board Discussion Paper on CCP Resolution, dated 10 December 2018, *available from* https://www.iciglobal.org/iciglobal/pubs/memos/memo31516

[8] Letter to the Secretariat to the Financial Stability Board from Patrice Bergé-Vincent, RE: Discussion paper on financial resources to support CCP resolution and the treatment of CCP equity in resolution, dated 1 February 2019, *available from* https://www.iciglobal.org/pdf/31588a.pdf

[9] FSB 2017 Guidance

[10] "relevant authorities" refers to the resolution authority and CCP's oversight and supervisory authorities

[11] CPMI-IOSCO's Principles for financial market infrastructures

[12] p6, Consultation

[13] No creditor worse off in liquidation
