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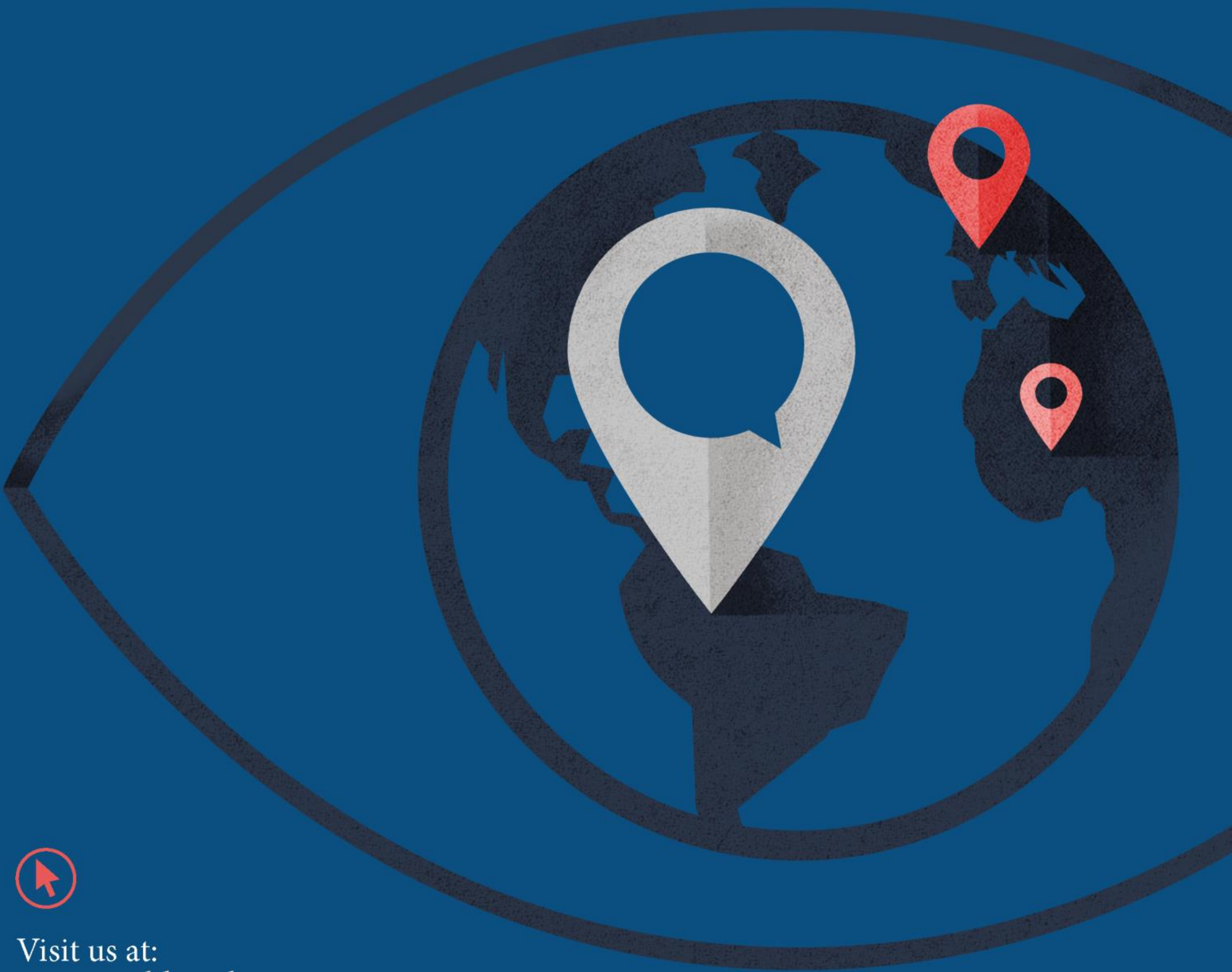
The Interplay Between Central Counterparty (CCP) Recovery and Resolution: A Global Perspective



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Background

The World Federation of Exchanges (WFE) is the global trade association that represents more than 200 Market Infrastructure Providers, of which more than 100 are Central Counterparties (CCPs) and Central Securities Depositories (CSDs). Our members include exchange groups and standalone CCPs[1].

Our members are both local and global, operating the full continuum of Financial Market Infrastructure in both developed and emerging markets. Of our members, 36 percent are in the Asia-Pacific region, 42 percent in EMEA and 22 percent in the Americas. The market capitalisation of entities listed on our member exchanges is $68.5 trillion, and around $26 trillion in trading annually passes through the infrastructures our members safeguard[2].

The WFE works with standard setters, policy makers, regulators and government organizations to support and promote the development of fair, transparent, stable and efficient markets around the world. We share regulatory authorities' 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.

Introduction

The assured and central role that CCPs played in the 2008 financial crisis demonstrated to the G-20 the systemic risk management benefits that CCPs provide. As such, in response to the crisis, G-20 countries and other jurisdictions have been seeking to implement derivative market reforms to encourage – amongst other things – more centralized clearing in particular products and markets. The resulting perception that this would lead to a concentration of market risk has led some to suggest that CCPs could now become the next "too big to fail", referencing the risks brought about by significant banks in the lead up to the crisis. In response, there has been a push for a "one-size-fits-all" approach to CCP resilience, recovery and resolution.

The WFE welcomes well-designed international efforts to enhance and strengthen the principles of resilience of the financial system post-crisis and supports further initiatives which encourage that objective. Markets are global, and as such it is only right that guidelines are designed to reflect this.

The WFE has previously publicly expressed support for initiatives such as the CPMI-IOSCO Principles for Financial Market Infrastructure (PFMI) and the FSB Key Attributes, and has sought to proactively contribute to the international debate on these issues and others – including CCP risk management, recovery and resolution.[3] In doing so, its members have contributed significantly to the strengthening of the system via the implementation of many post-crisis initiatives, including efforts to encourage central clearing of derivatives as per the G-20 direction.

At the same time, as global standards continue to be refined, national and regional authorities are considering how they might implement these. Here we offer perspectives on aspects of those initiatives which we believe will be most important to the safety and security of the broader financial system. Specifically:

- The boundary between recovery and resolution and the relative responsibilities of CCPs and market authorities; and

- Third country arrangements when entering and managing the resolution of a CCP.

[1] The WFE membership list can be found here
[2] As at end 2015
[3] WFE: CCP Risk Management, Recovery and Resolution – Aligning CCP & Member Incentives – October 2015
WFE: Response to CPMI-IOSCO Consultative Report on Resilience and Recovery of CCPs – October 2016
WFE: Response to FSB Discussion Note on Essential Aspects of CCP Resolution – October 2016

Executive Summary

CCPs have performed well through a range of significant market stress events including the 2008 financial crisis and - more recently - in the global market volatility caused by various events in 2015 and 2016.

They have proven to be wholly resilient in stressed market conditions and, rather than become complacent, CCPs continue to work with regulators and market participants to further refine and improve their resilience and ability to manage future market crises. This is generally performed in line with guidance provided by international standard setters to establish harmonised global principles.

We welcome unified and prudent international efforts to enhance and strengthen the resolution regime of CCPs to prepare for a potential worst-case scenario. That said, the scenarios that could potentially drive a CCP into resolution are exceptionally remote and represent a series of losses determined by regulators to be beyond "extreme but plausible"[4], such as the simultaneous default of several of the largest systemically important banks.

Whilst we also acknowledge that challenges remain with regional and/or local implementation due to differences in market structure, as well as legal and regulatory environments, we suggest regional and/or local authorities should seek to implement international standards as closely as possible to enhance the likelihood of cross-border cooperation in what are global markets.

We note the recent European Commission proposal of a framework for the recovery and resolution of CCPs[5] and within that process urge EU co-legislators to ensure the text makes specific reference to FSB and CPMI-IOSCO recommendations when it considers cross-border recovery or resolution events.

In summary, our view is that:

- **Recovery must be given every opportunity to be successful.** A CCP's recovery plans will include robust and appropriate tools that have been developed using industry guidance[6] and reviewed by the relevant authorities (as well as clearing members and market participants).[7] A CCP recovery is generally preferable to its resolution because of the latter's implications on the wider economy. Resolution should only be triggered if it is necessary to provide for continuity of clearing services and market stability once all recovery measures have been exhausted, including the contractual obligations clearing members have signed up to as part of their membership of the CCP.

- **It is not possible to design a single resolution strategy to effectively manage all potential stress scenarios**, as there will be significant nuances and specificities of each event to consider. The circumstances that could lead to a CCP recovery or resolution scenario are unprecedented and would far exceed what are considered extreme and plausible. Further, markets - and the firms operating within them - vary, as do national and regional laws and regulations. As such arrangements need to reflect and accommodate the unpredictable and idiosyncratic nature of such an event.

- **The WFE is a strong proponent for, and advocates the importance of cross-border cooperation** to ensure sound, smooth and orderly markets. However, there is a fine line to balance in terms of the level of prescription, and the number and nature of stakeholders engaged in the resolution process.

Below we set forth our further perspectives on some of the applications of CCP recovery and resolution from a global practitioner perspective. Further, we summarise the outcomes we seek to achieve on this matter in the accompanying document "CCP Recovery and Resolution: Desired Outcomes Relating to Entering (and Managing) Resolution".

[4] ESMA publishes results of EU CCP stress tests
[5] http://ec.europa.eu/finance/financial-markets/docs/ccp/161128-ccp-proposal_en.pdf
[6] For example, the guidance provided by CPMI-IOSCO's Recovery of Financial Markets Infrastructure report
[7] through the public rulebook and any consultation procedure required to implement the recovery tools

The Boundary Between Recovery and Resolution and the Relative Responsibilities of CCPs and Authorities

In general

Given the important role that CCPs play in enhancing financial stability, the key objective of CCP recovery and resolution planning must be the continuity of payment, clearance and settlement services and other essential CCP functions for the participants and markets served by the CCP. This requires:

- Ensuring steps taken for recovery and resolution do not interrupt the continued availability of liquidity;
- Relying, wherever possible, on the CCP's pre-existing and regulatory-approved loss allocation and risk management practices to increase certainty and predictability to the market;
- CCPs retaining the responsibility to design and apply the rules for their individual recovery in consultation with their primary regulators;
- Ensuring it remains the CCP's responsibility to apply the loss allocation and recovery processes (as per its rulebook) without external interference;
- Resolution authorities committing to working with prudential regulators and distressed CCPs during a market event to ensure they are able to identify the most appropriate trigger for resolution in that particular incident, whilst also monitoring market participant behaviour to ensure those market participants are fulfilling their responsibilities; and
- Regional policy makers refraining from implementing extra-territorial rules which may lead to instances of conflict of law in the case of cross-border CCP recovery or resolution events, and being mindful of the unintended consequences of incorporating policies which may be appropriate for bilateral, but not cleared, markets e.g. stays on close-out netting.[8]

As such, CCP recovery should be permitted and encouraged to run its course by regulatory authorities, so long as recovery remains viable. In general, regulatory authorities should not pre-emptively intervene in a recovery process, or trigger a resolution unless it is clear there will be a materially negative effect on market stability of not doing so.

The need for flexibility

An effective recovery and resolution regime should acknowledge - and allow for - the nuances and specificities of the extreme and unlikely event that could push a CCP into recovery or resolution. The unique characteristics of markets and the firms operating within them, as well as the national and regional laws and regulations encircling their operation, require that arrangements be made to reflect and accommodate these idiosyncrasies in the market and defend the CCP's role as the front-line arbiter which ensures its market remains safe and orderly.

CCP rulebooks should focus on establishing the appropriate tools and procedures to address stress in their markets in order to ensure a CCP's critical functions endure during market disruption. These rulebooks will include robust tools designed to ensure the return to matched book and full allocation of losses under a process run by the clearing house. Such rules have been developed using industry guidance[9] and reviewed by the relevant authorities (and market participants through the rule change governance procedures) ensuring CCPs are able to execute them appropriately and in a timely fashion.

However, by definition, any recovery and/or resolution event is beyond extreme but plausible as currently defined. As such it would be impossible to plan the precise tools to be used in any given scenario.

It is therefore essential that CCPs retain flexibility in designing recovery tools to consider market developments, innovation and the variety of products and markets served.

Further, CCPs must maintain similar flexibility in the way they implement recovery tools to reflect the specificities of different default situations. Without this flexibility, recovery plans may become too prescriptive, imposing a set of tools on market participants which are not suitable to the precise market event in question, increasing the likelihood of failure and entrance into resolution. Other than tools that may create clear negative incentives for participation in the market (such as initial margin haircutting), we see no benefit of authorities restricting or limiting the tools available to a CCP in managing its own recovery, as each will need to react to the specific situation at that point in time.

[8] See European Proposal here (Art 2 (41))
[9] For example, the guidance provided by CPMI-IOSCO's Recovery of Financial Markets Infrastructure report

The key stakeholders, their roles and responsibilities

There will be many stakeholders who will lay claim to a legitimate role in a CCP's recovery process: the CCP, its owners, the relevant authorities, any connected markets and other FMIs, and the users of the market (both clearing members and their clients).

It is important therefore to understand each participant's role and responsibilities before, during and after the event, to ensure all stakeholders are properly incentivised to act in the best interests of the market, rather than for individual gain.

In particular, in the event of multiple clearing member defaults - the most likely scenario that could drive a CCP into recovery or resolution – the only way the CCP can return to an orderly market is to restore their matched book. This is achieved through multiple auctions in which CCPs must rely on clearing members to actively participate and take on the defaulter's positions. Without this cooperation, recovery is more likely to fail. In order to ensure CCP participants are properly engaged in the recovery process to avoid unnecessarily triggering resolution, it is important the resolution authority makes clear it will closely monitor the behaviour of clearing participants in a CCP's recovery plan and loss allocation mechanism(s). Such oversight could serve as a deterrent for participants seeking to engage in behaviour that is not aligned with the interests of the financial markets, which may precipitate a CCP resolution. If such behaviour is identified, the resolution authority may have some course of action or may determine that further CCP recovery tools remain viable and thus prolong a resolution decision.

However, we do not believe any timing of entry into resolution, or potential triggers, should be publicised or defined in advance. This is because it is almost impossible to predict the order in which certain situations will occur, and publicising this in advance may provide perverse incentives for participants to change behaviour to ensure presumptive steps are reached. Further, if a resolution authority's complete strategy and timings of entries is public, it risks being hamstrung and not able to consider the specificities of the situation or unforeseen circumstances.

The trigger point – recovery to resolution

Whilst we think it essential that recovery be given every opportunity to be successful, particularly as resolution would likely have a significantly more negative impact on the overall market, the industry must prepare for a scenario in which recovery fails, no matter how remote that possibility. We agree with the principle that CCPs should describe the market-based tools they have available to manage losses if all recovery measures fail, with resolution authorities reserving the right to intervene when such wind-down approaches would result in a worse outcome for the overall market stability.

The decision regarding when to invoke resolution should only be taken if it is clearly necessary to provide for continuity of clearing services and market stability. We expect this would occur only once all recovery measures in the CCP's recovery plan – as defined in its rulebook – have been exhausted, or if the on-going execution of the recovery plan is obviously going to create systemic stress in the broader financial markets. There could also be consideration for triggering resolution if there is a risk of contagion across other FMIs and a risk of exacerbating financial instability.

We do not support resolution authorities seeking to interfere with – or override – the CCP's recovery process unless intervention is absolutely required to support financial or market stability. We therefore welcome aspects of the recent legislative proposal in the EU published by the European Commission which specifically state the relevant competent authority should be explicitly responsible for assessing whether any decision it makes has a negative impact on financial stability as they have a sufficiently broader view of the macro-economic environment.[10]

Where it is clear that recovery is not (or will not be) successful, the procedures to be followed by the resolution authority should be well defined in advance, transparent and established under relevant law or regulation. The uncertainty as to whether, when and to what extent an earlier intervention may take place will inevitably inject yet more uncertainty into an already complex situation.

It is important that resolution authorities maintain the necessary level of flexibility to determine the exact trigger point based on the specifics of the scenario at the time, but do not intervene prior to it becoming clear than no private options are available to effectuate recovery. Given the diversity of CCPs and the variety of risk management techniques they use, it will be virtually impossible to identify a useful and generally applicable objective indicator. The factors for determining timing of entry into resolution will be dependent on the stress scenario that threatens the CCP, and resolution authorities must be able to take the current market environment into account when making their evaluation.

The risks facing the market in the event of an incorrectly defined resolution trigger could severely hamper the effort to return to market stability. These risks include:

- The CCP might be placed into resolution *too early*, i.e. thwarting a market-driven successful recovery and creating inefficiencies in the market, leading to imbalanced losses amongst users;
- The CCP might be placed into resolution *too late*, i.e. too late to execute meaningful resolution actions, or access financial resources as they would all have been consumed in attempting to recover the situation; or

[10] See European Proposal here - Article 7 (f) and Article 21, 1 (c)

- Members' incentives to ensure the success of recovery tools could be damaged by an incorrect determination of the point of resolution, potentially incentivising members to embark on actions designed to trigger resolution points thereby leading to the CCP's resolution being synthetically expedited.

We therefore consider it vital to strike the right balance between providing sufficient certainty to participants (including the CCP) and leaving the authorities with enough flexibility – bearing in mind the significant risks which would be created by early entry - to make the correct decision to preserve and protect market stability.

Third Country Arrangements When Entering, and Managing, Recovery

Cooperation and collaboration

The WFE recognises the importance of cross-border cooperation and is a strong proponent of efforts to define global principles of risk management. This includes the formation of "crisis management groups" comprised of relevant stakeholders to ensure sound, smooth and orderly markets through any resolution event.

However, it is important that such cooperation be initiated well before a crisis occurs to ensure there is a common understanding of how the various bodies would work together when facing a market crisis.

Hence, the WFE considers it essential that authorities participate in practical engagement and "simulated exercises" to ensure awareness of available powers, how they would work, when they would need to be used, and the resulting impact on market participants and operators. This will ensure that stakeholder groups are practiced in how to properly communicate throughout the process, and identify whether the group of authorities that will be contributing to a resolution process is in fact too unwieldy, incorporates too many authorities, or makes decisions which are politically driven - all of which should be avoided. The risk of any-or-all of these occurring is it would inevitably lead to delayed decision-making in what is a fluid and dynamic situation which requires fast action.

Notwithstanding such pre-emptive steps, we are mindful of the challenges of coordinating responses of multiple regulatory authorities; we are also wary of the delegation of a CCP's resolution away from its local regulator.

We therefore believe the resolution of a CCP should principally be led by the resolution authority of the jurisdiction where the CCP is established. This ensures that the process is led by the entity with an in-depth understanding of the CCP, expertise in the markets which the CCP clears, and its legitimate interests/rights based on the local legal and/or regulatory framework.

Obviously, this leadership must be in close consultation with the CCP's home supervisory and prudential regulators, ensuring that – collectively - the regulators with the best information about the CCP in question remain responsible and can act in an efficient and timely way.

Further, given CCPs may operate cross-border and clear products which are traded globally, public authorities must ensure a consistent application of the recovery and resolution framework at an international level for it to be effective for financial stability. For example, international bodies such as CPMI-IOSCO and the FSB should at least be informed by the European Commission when it proposes recommendations for the negotiation of agreements between EU and non-EU authorities as part of its recent proposal.[11]

To facilitate cross-border cooperation, it is therefore essential to develop appropriate information sharing mechanisms which allow authorities to fully understand the impacts of their actions.

Suspension of clearing mandates

Taking Europe as an example, under EMIR there needs to be at least two CCPs clearing a particular asset class for the clearing obligation to be imposed.

In general, any suspension of the clearing obligation - whilst still allowing trading activity - would be based on the premise that the market is healthy enough to continue, but that no CCP exists to handle the business effectively.

If the resolution of a CCP is necessary, it is because recovery has failed, or it is clearly on a path to failure. In general, this would be due to the failure of one or more large clearing members.

[11] See Article 74, here

Given the significant effect of such an event, if it were to occur it is quite possible also that the market itself would no longer be viable because of the likely drain on liquidity from those players exiting; in general there exist regulatory requirements around having a "proper market" i.e. one that adequately reflects supply and demand. In other words, the market should be sufficiently liquid. It is difficult therefore to imagine a scenario in which the market has survived, but the multiple CCPs that serve it fail.

As such, it is not obvious to us that suspension of the clearing mandate is a necessary - or even helpful - step during a CCP's resolution. Rather, in this extreme scenario, it is essential that the relevant authorities consider the wider effect on the market (due to the *causes* of the CCP's resolution), and consider the use of the power to trigger a temporary suspension of trading in a product instead.

Further, we caution that a suspension of clearing mandates would likely add further systemic risk to an already highly stressed environment. Any clearing continuum would help the CCP to recover; a forced reduction in central clearing would simply exacerbate the CCP's resolution, as well as running counter to the incentives and goals of the G-20. Additionally, the promise of a suspension of the clearing mandate may encourage members to allow a CCP to reach an otherwise avoidable resolution in order to secure commercial benefits related to the relief from the clearing obligation.

As such, there appear many policy and operational issues regarding the practical implementation of suspending clearing mandates, including, but not limited to:

- It may not be possible for authorities to agree to conditions *ex ante* (or in crisis) under which a suspension would be acceptable;

- Difficulties in defining the scope of the authorities that would need to be involved in the decision;

- Unclear and potentially damaging impact on client clearing mandates; and

Adverse capital implications for market participants if transactions cannot be centrally cleared elsewhere.

Conclusion

The WFE welcomes international efforts to enhance and strengthen the financial system through regulatory reforms that will – amongst other things - increase market confidence whilst reducing systemic risk.

Investor confidence in public markets is crucial for the industry and, as markets evolve – and G-20 mandates continue to be implemented encouraging greater central clearing of financial markets – legislators and FMIs should work together to ensure that risks are appropriately mitigated without undue or unintended consequences.

Whilst we consider that recovery must be given every opportunity to be successful given the significant negative impact on the wider financial system if the CCP fails,[12] it is important nonetheless to have clear resolution expectations and sets of responsibilities in the event the recovery plan has been exhausted.

In particular, we note:

- A CCP's recovery plans will include robust and appropriate tools that have been developed using industry guidance and regulatory oversight; resolution should only be triggered if it is clearly necessary to provide for continuity of clearing services and market stability once all recovery measures have been exhausted.

- Flexibility is essential. There does not exist a single resolution strategy that will be effective for all potential scenarios, and so strategies should allow for the nuances and specificities of each event to be considered. Markets - and the firms operating within them - vary, as do national and regional laws and regulations. As such arrangements, tools and a CCP's ability to use them need to reflect this.

- Cross-border cooperation is also vital, not only in the day-to-day supervision of CCPs, but also in the lead into – and execution of – resolution. This is in order to ensure sound, smooth and orderly markets.

Our view is that nothing the resolution authority does should undermine recovery – in fact authorities should proactively encourage recovery. Furthermore, we caution that reversing a mandatory clearing structure which has proven its robustness during times of stress is unlikely to reduce systemic risk (which should be the authority's ultimate intention).

[12] particularly in light of the fact that the precipitating event was likely to be the failure of multiple globally systemic banks

Markets are global, and as such it is only right that guidelines are designed and implemented in that spirit. Ultimately, we are working towards the shared objectives of achieving fair, robust and resilient markets in which investors can have confidence. In that regard, the WFE and its members are now - and will continue to be - engaged with national and international agencies to ensure this.