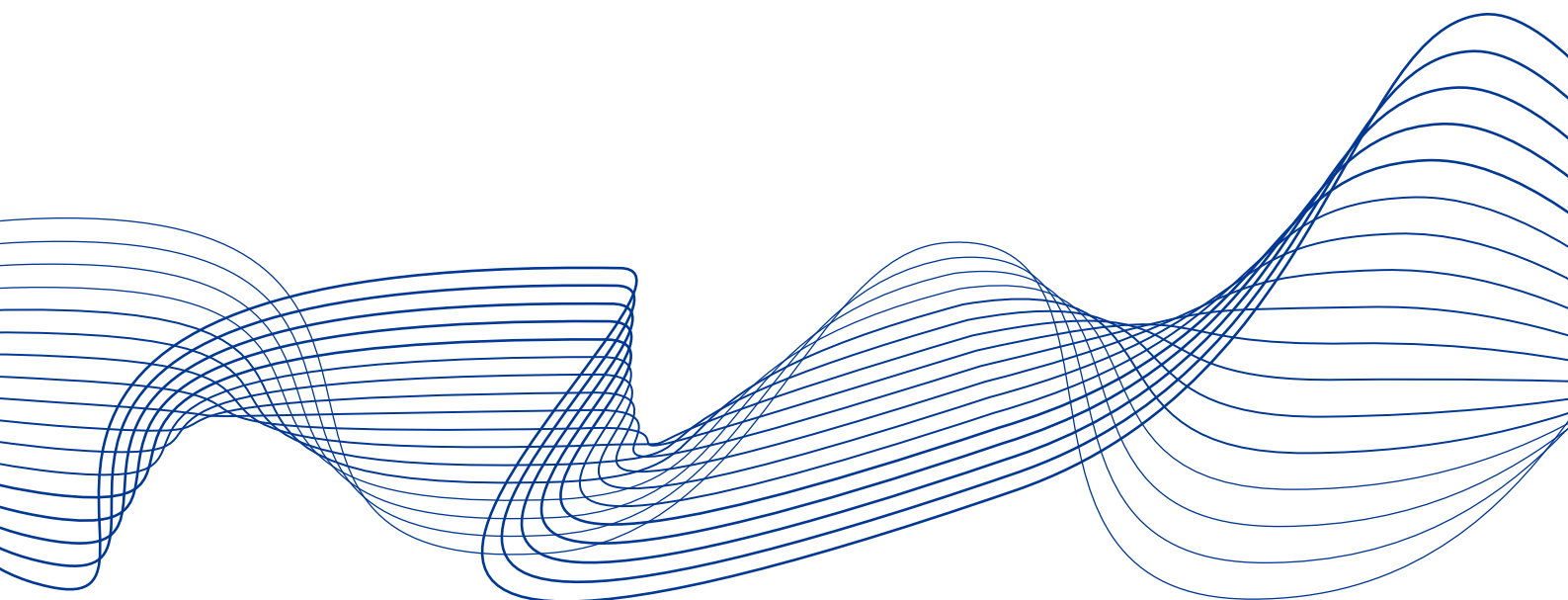


Opinion on a central counterparty recovery and resolution framework

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ESRB
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Contents

Executive Summary	2
Section 1 Introduction and context	3
Section 2 Proposals and conclusions	4
2.1 Recovery phase	4
2.2 Resolution planning	6
2.3 Assessment of financial resources	6
2.4 Resolution tools	7
2.4.1 List of resolution tools	8
2.4.2 Cash calls	8
2.4.3 Full tear-up	9
2.4.4 Additional resolution tools	10
2.4.5 Initial margin haircutting	10
2.4.6 Compensation to clearing members in the form of equity	11
2.5 Cross-border cooperation	12
2.6 Cooperation with bank resolution authorities	14
2.7 Suspension of central clearing obligation	14
2.8 Conditions for public financial support	16
Imprint	17



Executive Summary

The ESRB welcomes the ongoing discussion in the European Union on the recovery and resolution regime for CCPs. The European Commission published a legislative proposal in November 2016 for a CCP recovery and resolution regime for the EU¹. Discussions are ongoing among EU Member States on this draft legislative text, with the latest Presidency compromise text (as of the date of this opinion) having been published in April 2017². The ESRB refers to this latest document (“the Proposal”) in its input. It has previously noted that the systemic nature of CCPs creates the need for an effective recovery and resolution regime, despite the likelihood of their failure being extremely low³.

This opinion highlights areas where the Proposal could be refined to better address potential financial stability issues. With this opinion, the ESRB aims to provide input to the ongoing legislative debate and the regulatory dialogue on CCP recovery and resolution issues. The ESRB has identified a number of areas where the provisions of the Proposal should be amended or expanded in order to better address macroprudential considerations. The ESRB stands ready to contribute further to the discussions on the Proposal as knowledge of the macroprudential analysis of the CCP recovery and resolution regime develops.

The ESRB makes the following suggestions with regard to the Proposal:

- Further harmonise recovery actions in secondary legislation;
- Strengthen, where necessary, the financial stability mandate of CCP supervisory authorities in the EU;
- Strengthen resolution planning by conducting an impact assessment and an analysis of existing financial resources;
- Include further resolution tools and clarify the use of the proposed tools;
- Enhance cross-border cooperation and cooperation with bank resolution authorities;
- Further clarify the conditions for the suspension of clearing obligations and the use of public financial support.

The ESRB puts forward some proposals for the composition of the resolution colleges. The ESRB is mindful that the overall architecture of the supervision of EU CCPs is under review as part of the Commission’s public consultation on the operations of the European Supervisory Authorities⁴. The Commission also addressed the framework for the recognition of third-country CCPs in June by publishing its proposal for new legislation in this regard. The ESRB proposals should therefore be considered from a dynamic perspective given the evolving supervisory structure of CCPs.

¹ **Proposal for a Regulation of the European Parliament and of the Council on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, and (EU) 2015/2365.**

² **Proposal for a Regulation of the European Parliament and of the Council on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, and (EU) 2015/2365 = Presidency compromised text.**

³ ESRB (2016), **Macroprudential policy beyond banking: an ESRB strategy paper** and ESRB (2016), **ESRB report to the European Commission on the systemic risk implications of CCP interoperability arrangements.**

⁴ The consultation can be found here: http://ec.europa.eu/info/consultations/public-consultation-operations-european-supervisory-authorities_en.



Section 1

Introduction and context

CCPs are playing an increasingly important role in the post-crisis financial system, improving its overall resilience. An increasing number of standardised OTC derivatives are now cleared through a CCP, with certain categories being subject to mandatory central clearing in line with a mandate given by the leaders of the G20 in 2009 to mitigate systemic risks. It is generally accepted that central clearing via CCPs reduces counterparty credit risk and therefore contributes to financial stability. Counterparty credit risk is reduced for the CCP's participants⁵, who are exposed to a single counterparty for their contracts rather than multiple counterparties, the creditworthiness of which may vary substantially. The CCP, in turn, manages its own counterparty credit risk by collecting collateral (in the form of margins and contributions to default funds).

Due to the risk of contagion in the event of the financial distress of a CCP, stemming from its central role in financial markets, a comprehensive regime for CCP recovery and resolution is crucial. As a result of private incentives for the use of CCPs, as well as legally mandated central clearing for an increasing number of financial contracts, these financial market infrastructures have become critical hubs in the financial system, linking multiple financial actors and concentrating significant amounts of their exposure to diverse risks. Regulatory reforms, most notably Regulation (EU) No 648/2012 (EMIR)⁶ within the EU, have significantly enhanced CCPs' resilience. However, such regulatory efforts do not eliminate the possibility of a CCP failure, for instance in a scenario beyond that provided for in its resilience arrangements or when the resilience efforts may harm financial stability.

With this input, the ESRB would like to contribute to the ongoing discussion in the EU from a macroprudential perspective. In developing its opinion, the ESRB has been mindful of its mandate to monitor and assess potential systemic risks. This includes in particular the risks of a disruption to financial services caused by a significant impairment of all or parts of the EU financial system that – regardless of whether this occurs in groups of Member States or only in individual Member States – could potentially have serious negative consequences for the internal market and the real economy⁷.

There are limitations on macroprudential analysis of a CCP recovery and resolution regime. The ESRB notes that a CCP failure is a remote scenario and there have been no recent experiences under comparable circumstances. There has also been little primary academic research in this field⁸. Macroprudential analysis of a CCP recovery and resolution regime is therefore challenging at this stage and lacks the necessary evidence. As a result, the ESRB may undertake further analysis on these issues or other aspects of the Proposal.

⁵ In this opinion the term "participant" is used to refer collectively to clearing members, their clients and indirect clients.

⁶ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN>

⁷ See also Recital 27 of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board (OJ L 331, 15.12.2010, p. 1).

⁸ As a recent example, a novel idea for a CCP bail-in tool was presented in Duffie (2015). It suggests that clearing participants contractually grant the CCP access to their initial margin at the end of the waterfall, while the notional of all positions (not only from the defaulted portfolio) are simultaneously reduced.



Section 2

Proposals and conclusions

The Proposal is largely in line with emerging international standards for CCP recovery and resolution regimes⁹. International standard-setting bodies have been carrying out work to that end¹⁰. The ESRB considers the consistency of the Proposal with this work to be important given that third-country CCPs provide clearing services in EU Member States, while CCPs domiciled in the EU provide their services in third countries. Careful consideration will also need to be given to the interaction of the recovery and resolution regime in the EU with third-country CCPs and participants. Should any new material risk or significant regulatory developments arise in this context, the proposal should be updated without delay.

The ESRB has identified a number of areas where the Proposal could be refined to better address potential financial stability issues. The following areas of the Proposal, which are set out in more detail below, could be amended or expanded in order to address macroprudential considerations: (1) the recovery phase; (2) resolution planning; (3) financial resources; (4) resolution tools; (5) cross-border cooperation; (6) cooperation with bank resolution authorities; (7) the suspension of the central clearing obligation; (8) the use of extraordinary public financial support.

2.1 Recovery phase

Recovery actions fall largely within the remit of CCP resilience. They are triggered when a CCP is facing a serious difficulty that cannot be resolved through the usual default management procedures. During a recovery phase, a CCP is given the opportunity to undertake measures to restore its financial position under the supervision of its competent authority. This keeps the relevant actions in the ownership of the CCP and its stakeholders (through, for instance, the CCP's risk committee), under the aegis of the competent authority.

The ESRB welcomes the fact that the Proposal includes provisions on recovery plans and actions, given their macroprudential dimension. The recovery phase is carried out by the CCP itself according to its contractually agreed rules and recovery plan and with the intention of restoring the financial position of the CCP. The recovery actions, which are included in the recovery plan, should be comprehensive and forward-looking and should set appropriate incentives for all stakeholders to take part in the recovery process, particularly with regard to the risk of moral hazard. Since CCP recovery actions also have macroprudential consequences, the ESRB welcomes the fact that the Proposal covers these important aspects.

The role of a CCP's national competent authority in the recovery phase is crucial; however, the ESRB notes that not all of them have a financial stability mandate. Many of the recovery tools which must be included in a CCP's rulebook and therefore accepted by its clearing

⁹ At least one ESRB member institution believes that the 28 April 2017 Presidency compromise text is not in line with international guidance on certain aspects of the "no-creditor-worse-off" principle.

¹⁰ This opinion has, for example, considered the CPMI IOSCO [Principles for Financial Market Infrastructures](#) and its [related recovery report](#), the FSB [Key Attributes of Effective Resolution Regimes for Financial Institutions](#), including the FMI Annex and the FSB draft ["Guidance on Central Counterparty Resolution and Resolution Planning"](#). Following approval of this opinion the FSB published its final guidance on 5 July 2017.



participants may have an important impact on financial stability. The CCP's competent and resolution authorities should take these implications into account in their assessment of recovery plans and oversight of potential recovery actions, to ensure that such actions are not detrimental to financial stability. The ESRB welcomes the fact that Article 7 of the Proposal requires competent authorities, resolution authorities and ESMA to duly consider "...the impact of any decision or action or inaction on the financial stability or fiscal resources of those Member States [where the CCP provides its services] and the Union as a whole"¹¹. However, the ESRB notes that CCPs' competent authorities do not always have a financial stability mandate, which might limit their ability to oversee CCPs from a financial stability perspective. It believes that the Proposal, while respecting the autonomy of Member States in deciding the responsibilities of national competent authorities, could recall the need for a financial stability mandate for these authorities. This could be achieved, for instance, by including a reference to financial stability in the current Recital (32).

A minimum set of recovery tools could be identified to be implemented across European CCPs, to mitigate some financial stability concerns related to the recovery process. The ESRB welcomes the fact that the Proposal indicates that "... The absence of common rules and tools for how distress or failure in a CCP would be handled can affect participants' choice to clear and CCPs' choice of their place of establishment, thereby preventing CCPs from fully benefiting from their fundamental freedoms within the single market." However, the ESRB notes that the Proposal could be more specific with regard to recovery tools. While preserving a certain level of flexibility, given the differences across CCPs (e.g. a CCP which only clears cash instruments might require a different set of tools to a CCP which clears derivatives instruments) the Proposal could envisage further specification of recovery actions as part of secondary legislation, in order to promote convergence and, more importantly, preserve a proper alignment of the various stakeholders' incentives in the transition from business-as-usual status to a recovery phase. The ESRB notes that Article 10(3) of the draft Proposal mandates ESMA to develop draft regulatory technical standards (RTS) specifying the implementation of the assessment by competent authorities and resolution colleges of the impact of a CCP's recovery plan. The ESRB stands ready to perform a consultative role in respect of the RTS detailing the assessment of the impact of the recovery plan in terms of financial stability¹². Accordingly, the text of the last indent of Article 10(3) could be modified by including a consultative role for the ESRB in relation to the implementation measures referred to in letter (b) of paragraph 3, concerning the impact of a CCP recovery plan from a financial stability perspective.

¹¹ This provision mirrors Article 23(2) of EMIR which requires "competent authorities, in the exercise of their general duties, to duly consider the potential impact of their decisions on the stability of the financial system in all other Member States concerned".

¹² Article 10(3) of the Proposal reads:

When assessing the recovery plan, the competent authority and the resolution college shall take into consideration

(a) the CCP's capital structure, its default waterfall, the level of complexity of the organisational structure and the risk profile of the CCP, and

(b) the impact that the implementation of the recovery plan would have on clearing participants, their clients (in particular where such clients are designated as O-SII in accordance with the CRD) , financial markets served by the CCP and on the financial system as a whole,

(c) whether the recovery tools specified by the recovery plan create appropriate incentives for the CCP's owners and clearing participants as relevant to control the amount of risk that they bring to or incur in the system, monitor the CCP's risk-taking and risk management activities and assist in the CCP's default management process.

In order to ensure uniform conditions and application of paragraph 3 of this Article, ESMA shall develop draft RTS specifying implementation of (a) and (b) of paragraph 3.



2.2 Resolution planning

Resolution authorities should use the resolution plans to assess the impact of the resolution tools on financial stability in the EU and all relevant jurisdictions. Resolution of a CCP is triggered when recovery actions have failed, have proved to be ineffective or are expected to be ineffective. Resolution actions could also be triggered if the recovery process is considered to be detrimental to financial stability. Preservation of financial stability is thus a key objective of a resolution regime and CCP resolution authorities will be mindful of the far-reaching consequences of their actions. However, the resolution planning phase is an opportunity for proactive analysis of such issues with the benefit of time and data availability across the board, even if all details cannot be known in advance. Therefore, CCP resolution authorities should already be required in the resolution planning phase to specify how they will assess the financial stability implications of their actions. As with all other aspects of the resolution plan, this should not necessarily bind an authority's discretion during a resolution phase, but it could inform its actions. This assessment should include the impact of the tools on other jurisdictions, regardless of their participation in the resolution college, or on different parts of the financial markets (such as the insurance and pension funds sectors).

The relationship between clearing participants in a resolution phase could be further clarified. The Proposal does not give specific indications about the extent to which clearing members will be able to pass on cash calls and other resolution interventions to clients and indirect clients for their positions (via the contractual arrangements in place). Clarity on this point is crucial, however, since resolution actions could lead to contagion effects and/or have an impact on the incentives to clear. Therefore, the text of the Proposal could be amended to support a clear disclosure of any client obligations and, as a minimum, require clearing members to ensure that their clients are aware of whether and to what extent they could be exposed to the application of a CCP's resolution tools.

2.3 Assessment of financial resources

The recovery or resolution of a CCP and in particular the re-establishment of a balanced book and the absorption of losses will largely rely on clearing participants. Such actions, possibly in a moment of widespread instability, can have consequences for the wider financial system. By the nature of their activities and their potential impact on financial stability, the manner in which a CCP failure is managed is important with a view to addressing a number of macroprudential concerns around counterparty exposure, risk of contagion and the incentives of financial market participants. CCPs, unlike banks, are not leveraged entities and do usually not hold risk-bearing debt that can absorb losses in a crisis. Indeed, their loss absorption relies mainly on (i) the financial resources pre-funded by their participants, and (ii) the CCP's capital contribution to the loss absorption (which is relatively limited in terms of size, and thus is more in the way of an incentive mechanism for the CCP itself, i.e. its shareholders, to adopt prudent risk management measures). In addition, once the pre-funded resources are exhausted a CCP may impose additional requirements on its participants, such as cash calls at the end of the waterfall, as defined by law (taking due account of international guidance) and by reference to the participants' use of the clearing service. These resources are not pre-funded, however. Any recovery or resolution would thus have to rely on the willingness and capacity of a CCP's participants to fund resources and absorb losses stemming from that exercise. But a CCP failure is very likely to happen at a particularly strained moment for the market, when clearing participants may lack resources to contribute, may be under resolution themselves or may end up in resolution as a result of the



CCP's resolution actions. The above considerations point to significant macroprudential concerns and a risk of contagion that could arise from a CCP recovery and resolution regime.

The resolution authority should regularly assess the suitability of the resolution tools and the resolution actions envisaged with regard to their performance risk and procyclicality.

Given a CCP's capital structure and absence of loss-absorbing debt, its loss absorption capacity when in difficulty relies to a large extent on clearing participants through either pre-funded resources (e.g. default fund in the course of ordinary default management) or instantly funded arrangements (e.g. cash calls). Such arrangements, while contractually agreed with clearing participants, carry a performance risk, especially when they rely on clearing participants in other jurisdictions which are under the responsibility of their national competent authority and may, in a crisis, come under the responsibility of their resolution authority. This could undermine the credibility of the recovery and the resolution plans and raise moral hazard concerns in terms of expectations of extraordinary public financial support. Recovery and resolution arrangements, especially cash calls, could also be procyclical and exaggerate liquidity shortfalls of clearing participants in times of financial distress. Their implementation by the CCP itself or by the resolution authority could therefore lead to serious financial instability and spill-over effects under certain circumstances. In the context of the resolvability assessment, the resolution authority should therefore regularly assess the suitability of the tools and the resolution actions envisaged against the resolution plan and the resolution scenarios and try to estimate their impact on financial resources. Articles 17, 44 and Section C of the Annex to the Proposal could be modified accordingly.

2.4 Resolution tools

The Proposal provides authorities with a set of tools for re-establishing a matched book and absorbing the ensuing losses to the CCP, in line with developing international guidance. It

includes, but is not limited to, the termination (tear up) of contracts, resolution-specific cash calls and variation margin gains haircutting¹³. It does not preclude the forced allocation of contracts or the use of initial margin haircutting. International guidance on CCP resolution permits the use of both of the latter tools, but only as a last resort after careful consideration of their impact on financial stability and the incentives to clear¹⁴.

A resolution authority should apply the least disruptive effective measure; however no measure is without side effects. Since a common feature of a majority of the tools is that they distribute losses, they could impact financial stability in terms of their procyclicality. When deciding on the resolution tool, the resolution authority needs to consider the respective circumstances, i.e. liquidity/funding of clearing participants, their ability to bear losses, their open positions and the resulting contagion risk.

The operation of a number of the tools set out in the Proposal could be improved through technical amendments. In particular, these proposed amendments are designed to limit detrimental macroprudential consequences such as a possible risk of contagion, misalignment of incentives or uncertainty of participants' obligations. Some suggestions are detailed below.

¹³ Reduction in the value of any gains payable to in-the-money counterparties.

¹⁴ See paragraphs 2.7 and 2.11 of the Financial Stability Board draft Guidance, op. cit.



2.4.1 List of resolution tools

Discretionary powers of resolution authorities counteract the moral hazard problem, but are also a source of legal risk. Article 27 of the Proposal includes a list of the resolution tools that the resolution authority can use. It is a non-exhaustive list, since Article 27(1)(e) states that “any other resolution tool consistent with Articles 21 and 23” may be used. With this ambiguity, it could be argued that clearing participants have a strong incentive to engage and cooperate in the resolution process to the fullest extent possible, in order to maintain control and impact on the final outcome. At the same time, any tool not stipulated in the Proposal would be subject to general legal safeguards. At this stage the substantially complete range of resolution tools that have been considered internationally is included in the Regulation.

Moreover, the use of resolution tools beyond those included in the Proposal is a source of uncertainty for stakeholders. This could create some uncertainty for clearing participants, as they might not have full information about the implications of the resolution. As such, they may not be adequately prepared for other resolution tools. Notwithstanding the possibility for clearing members and CCPs to extend the list of tools available in the resolution phase by extending the list of tools in the recovery phase through CCPs’ own rules subject to regulatory approval (see below), most ESRB members are of the view that an exhaustive list of resolution tools is important in terms of transparency, credibility and communication about resolution actions. It also avoids a situation where the resolution authority applies an insufficiently tested tool, which might result in severe consequences for financial stability. In their view, the list of available resolution tools set out in the Proposal should be exhaustive. Other ESRB members place greater weight on flexibility to enable authorities to deal with unforeseen circumstances and believe that the list of resolution tools included in the legislation should be non-exhaustive.

The resolution authority is empowered by the Proposal to use tools contained in the CCP rulebook. These recovery instruments are based on an agreement between a CCP and its clearing members, and are subject to the oversight of a CCP supervisory authority. Their inclusion in the CCP rulebook also provides for certain safeguards, such as that they are legally determined, known to stakeholders and have predictable implications. This provision further highlights the need to introduce some minimum standards for CCP rulebooks or expand the CCP supervisory authority mandate for financial stability, if not yet stipulated.

The Proposal should explicitly provide grounds for regular review clauses, should new or refined CCP resolution tools be considered in the future. Resolution tools may evolve over time and the resolution authority should be equipped with a set of resolution tools that is as extensive as possible. It is to be expected that launching the implementation of the CCP recovery and resolution regime in the EU and globally will result in more regulatory and academic research in this field. With further case studies by market participants and novel academic research in this area, new or refined resolution tools might become available. The ESRB therefore takes the view that the Proposal should provide for regular updates of the Proposal as both European and international policy evolves.

2.4.2 Cash calls

To reduce the performance risk and procyclicality of cash calls, clearing participants should be able to estimate this contingent liability ex ante in both recovery and resolution. If clearing participants do not know the potential extent of their exposure to the CCP, they may not be able to contribute when this becomes necessary. This challenges the effectiveness of the resolution tools and can lead to spill-over effects if the tool is enforced anyway. Furthermore, a proportionality



principle should be ensured whereby the contribution is equivalent to the clearing participant's contribution to the CCP's resources.

The performance risk of cash calls could be further reduced if, under certain circumstances, they would be temporarily covered by the initial margin of clearing participants. The initial margin of clearing participants could also protect against the non-performance of a cash call, for example by explicitly including such use by resolution authorities in the rulebook of CCPs, with the appropriate safeguards. If a clearing participant is unable (for example due to operational problems) to fulfil the cash call on time, it should be possible for the resolution authority to tap into its initial margin to lower the liquidity risks for the CCP without automatically placing that clearing member in a fully fledged default. The obligation to fulfil the cash call would be switched into an obligation to replenish the initial margin by a certain deadline, but the CCP would have more liquid resources available immediately. The additional time, although just one business day, for clearing participants to provide the resources necessary to replenish their initial margins before being placed in fully fledged default could significantly ease their potential liquidity strains.

The current wording of Article 31 is unclear with regard to how many times the resolution authority could require clearing members to provide a contribution in cash. It is possible that the resolution authority may request multiple smaller cash calls rather than a single large one, in order to facilitate liquidity management for clearing participants. The phrase "up to an amount equivalent to their contribution to the CCP's default fund" may be interpreted as determining the distribution of each cash call rather than the total amount that can be sought.

A different basis for the maximum amount of the cash call could better reflect the trading position of clearing members. The Proposal could include the possibility for the maximum amount of the cash call to be calculated on the basis of the current amount of initial margin requirements instead of the default fund contribution. The added value of this alternative basis would be that it could better reflect the actual trading position of clearing members, which may change significantly each day. In particular, whereas initial margins depend mainly on the actual size of the open positions of individual clearing members, CCPs use different measures to calibrate default fund contributions, for example based on the size of the largest open positions outstanding at the CCP.

2.4.3 Full tear-up

A full tear-up of all the CCP contracts contradicts the objective of a resolution regime to maintain critical functions by the resolved entity for the economy. The current wording of Article 29(1) allows the resolution authority to tear up "the contracts of the affected clearing service or asset class" or "the contracts of the CCP in resolution". This provision serves the specific purpose of re-establishing a balanced book. Without the necessary safeguards, however, it could disrupt the critical service(s) that a CCP provides.

A full tear-up could have significant financial stability implications and requires cooperation with other authorities. The CCP resolution authorities should be aware of the risks of this tool, as it might unwind hedges of clearing participants and could lead to unintended contagion effects. Close cooperation with banking supervisors and banking resolution authorities is therefore required. When contemplating a full tear-up, the resolution authority should ensure that either the clearing service in question is not critical or that the continuity of any critical service is guaranteed, e.g. through a bridge CCP or sale of business.



2.4.4 Additional resolution tools

Without prejudice to the freedom of the resolution authority to choose the appropriate actions, the Proposal should include a refined list of the resolution tools available. Article 27 of the Proposal includes a list of the resolution tools that the resolution authority can use. Building on the draft FSB Guidance, some tools could be included in the Proposal, subject to conditions and appropriate safeguards, to increase the transparency and predictability of their use:

- **Auctions:** In the context of their resilience arrangements, CCPs often include in their rulebooks the ability to run an auction of a defaulted clearing member's positions as a way of allocating unmatched positions. The benefits of this tool are that it can re-establish a balanced book in a voluntary manner and provides an objective price discovery method for outstanding positions. The effectiveness of auctions in the resolution process could also be enhanced by the threat of forced allocation (see below). The ESRB welcomes the fact that the Proposal includes the possibility of using auctions (Recital 52) and would suggest that it be updated so that auctions are included in the list of possible resolution tools. The Proposal should also clarify that excessive loss for the CCP beyond any posted margin will still have to be allocated according to the other available tools.
- **Forced allocation:** This tool involves forcibly allocating positions in cases where the voluntary purchase of those positions (e.g. through an auction) has failed. The main advantages of this tool are that it can help to completely re-establish a balanced book and set the proper incentives for clearing participants so that they participate more actively in the auctions. The tool could be potentially discriminatory and disruptive, though, as it would allocate contracts to an undefined group of clearing participants who may not have the capacity to service them, with potential spill-over effects on their solvency. Forcibly allocated positions also have to be covered by margins, leading to margin calls with possible procyclical effects. The Proposal should include this as a potential tool, subject to the safeguards that the method of allocating positions should be set out ex ante, based on application of the principle of proportionality, and that no other option would result in a better outcome in terms of financial stability.

2.4.5 Initial margin haircutting

The legislative text should clarify whether initial margin haircutting is permitted and under what conditions. This tool reduces the amount of initial margin paid in to collateralise clearing activities. According to the February 2017 consultative FSB Guidance¹⁵ it is not ruled out as resolution tool but its use should be limited to use as a last resort tool only.

From a macroprudential standpoint initial margin haircutting (hereinafter IMHC) has important drawbacks. First, like other resolution tools such as variation margin gains haircutting (VMGH) and extraordinary cash calls, its use is at odds with the "defaulter pays" principle. Second, IMHC can weaken the incentives to centrally clear instruments that do not fall under the central clearing obligation. Third, like other resolution tools it could have procyclical effects since initial margin requirements are likely to increase in times of widespread financial instability characterised by major bank failures, which is a likely underlying scenario for a CCP crisis. In such a situation clearing members would already face increased costs for servicing their central clearing needs in

¹⁵ FSB Guidance on Central Counterparty Resolution and Resolution Planning, Consultative Document.



the form of posting liquid collateral, and this procyclical effect would be further aggravated by a potential haircutting of such collateral. Fourth, this tool would also leave the CCP under-protected during the period before the initial margin is replenished. In the event of further defaults, the CCP may not have enough resources to deal with them (in other words the remaining initial margin of defaulting clearing members might not be sufficient after application of the tool), which could not only threaten the continuance of critical functions but also lead to unintended contagion effects. In addition, bearing in mind that national insolvency laws in some individual EU Member States may currently treat initial margin as bankruptcy-remote, it may not be feasible to exercise IMHC in all EU jurisdictions without the risk of breaching the “no creditor worse off” safeguard unless those laws are adapted accordingly.

However, IMHC has also some positive features from a macroprudential perspective. The apparent main advantage of this tool is that initial margins constitute a large pool of pre-funded resources that are immediately available to the CCP in such an emergency situation. Furthermore, a haircut of initial margins ensures that the losses for each participant are capped and predictable (i.e. they cannot exceed the amount of initial margin posted by that participant) and would be transparently attributable. The availability of these pre-funded resources provides another means of using private sector resources in resolution and thus decreases the likelihood of using public funds. In view of the arguments set out above, the ESRB welcomes and fully supports the fact that the Proposal explicitly prohibits IMHC in the recovery phase. However, the Proposal does not contain provisions regarding the use of this tool in the resolution phase. The lack of an explicit reference to IMHC in the resolution provisions, coupled with a non-exhaustive list of resolution tools (see section 2.4.1), could generate uncertainty in the interpretation of the Regulation.

The ESRB believes that – rather than remaining silent on this issue – the legislative text should take a clear stance on the inclusion or exclusion of IMHC as a resolution tool. This avoids ambiguity which could generate improper expectations regarding recourse to public funds and have a negative impact on the incentives to centrally clear or the choice of collateral¹⁶. The ESRB sees two options, the first of which would be to prohibit IMHC altogether in the resolution phase. In this case, while providing clarity and avoiding the drawbacks mentioned above, appropriate additional safeguards should be put in place to avoid improper expectations regarding recourse to public funds. The second option would be to not rule out IMHC but limit it as much as possible, and to permit resolution authorities to consider its use only when all other resolution tools have been exhausted or would be likely to produce worse results in terms of financial stability and recourse to public funding. In this case, the Proposal should contain separate provisions specifying the terms and conditions under which this tool could be used (the general provisions of draft Article 27 would be insufficient) as a last resort tool, in line with the draft FSB Guidance.

2.4.6 Compensation to clearing members in the form of equity

Any compensation arrangements should take account of the possible negative impact on clearing members’ and shareholders’ incentives to participate in recovery measures.

According to Article 27(5), clearing members who have suffered losses could potentially receive compensation in the form of equity in the CCP or a contingent debt claim against the CCP.

¹⁶ IMHC could have implications for the collateral mix that clearing members choose to post to a CCP, which in turn affects the CCP’s liquidity management. If IMHC is limited to cash collateral, and securities posted as collateral at a custodian are bankruptcy-remote, IMHC would incentivise the posting of more securities collateral and less cash collateral.



However, the possibility of such compensation could distort clearing members' incentives to participate properly in the recovery phase. In this respect, the ESRB welcomes the fact that the requirements for recovery plans (Section A of the Annex to the Proposal) include the need to "create appropriate incentives for the CCP's owners, direct and indirect participants", since it must be ensured that these are preserved. Under this condition, the ESRB supports this tool and underlines the need to take proper account of the potential implications of possible compensation when assessing recovery plans.

Distributing losses among clearing participants resulting from non-default events may create wrong incentives for CCP shareholders. This should be taken into account by the resolution authority when deciding upon any related compensation arrangements. Losses generated by the materialisation of operational risk, cyber-attacks, fraud, and in some cases investment losses too, are largely the responsibility of shareholders. Unless proper incentives for prudent risk management at CCPs and sufficient capital buffers are ensured, CCP owners may have incentives to share such losses among clearing participants.

2.5 Cross-border cooperation

The Proposal should provide for a wider scope of authorities to be consulted, while maintaining a manageable size for resolution actions. The ESRB welcomes the objective in the Proposal that resolution plans and actions should consider the need to protect financial stability in all EU Member States where CCPs provide services¹⁷. This approach is in line with the ESRB's view that systemic risk may arise not only at the aggregate EU level but also at EU Member State level¹⁸. Relevant authorities should have meaningful access to information that concerns institutions in their jurisdictions, as well as a mechanism by which to express their views on a CCP's resolution plan. In addition, authorities would need to make appropriate preparations for the potential resolution of a CCP, providing services to participants in their jurisdictions and taking steps to facilitate the necessary resolution actions. It is therefore crucial that authorities from all EU Member States for which the resolution of the CCP would have a systemic impact are involved, particularly in the resolution planning for the CCP, and have access to information on actions concerning institutions in their jurisdictions. The current provisions in the Proposal concerning cross-border cooperation, including the composition of resolution colleges¹⁹, should better reflect such local systemic risks and feasibility concerns and provide a sounder basis for consultation with a wider group of relevant authorities from all relevant EU Member States, at the appropriate level and frequency. As a minimum, the Proposal should provide for the level of cooperation advocated in the relevant international guidance²⁰. When considering the level and frequency of this cooperation, the Proposal should nevertheless consider the need to preserve the effectiveness of the decision-making process.

Further consideration could be given in the Proposal to expanded cooperation arrangements. The composition of the resolution college in the Proposal largely mimics the

¹⁷ See Recitals 16 and 79 and Articles 7(f), 13(3), 16(2), 17(4) of the Proposal.

¹⁸ See, for example: ESRB (2015), **ESRB report on issues to be considered in the EMIR revision other than the efficiency of margining requirements**.

¹⁹ See Article 4(2) of the Proposal.

²⁰ See, paragraphs 9.5 – 9.7 of the Financial Stability Board draft Guidance, op. cit.



composition of the CCP supervisory college. The ESRB takes the view that the Proposal should require CCP resolution authorities to establish effective arrangements for cooperation and information sharing with relevant authorities from all relevant EU Member States where the CCP is deemed systemically important, in case those authorities are not represented in resolution colleges. There are multiple mechanisms by which these non-college EU jurisdictions could be involved in information sharing and resolution planning. Such arrangements could, for instance, entail the establishment of a “core” and “expanded” resolution college, with the latter dealing solely with high-level resolution planning and serving as an information sharing platform. Alternatively, the Proposal could include the option of specifying observer status or notification requirements for those authorities concerned and the possibility of bilateral information sharing with the CCP resolution college. Whatever mechanism is used, it is important that the ultimate aim of preserving financial stability in all EU Member States is achieved. The ESRB believes that during resolution planning the CCP resolution authority should share relevant information on the resolution plan with relevant authorities which, according to the Proposal, would not be represented in resolution colleges but would be heavily affected by the CCP’s problems. This would enable them to understand the key elements of the resolution plan and the impact of the resolution actions being considered on their jurisdictions. The CCP resolution authority should seek input from those authorities as appropriate, and consider any information or feedback provided by them. The Proposal could also entail the creation of a centralised conduit for information exchange and cooperation among relevant authorities from the EU Member States, for example a European Supervisory Authority focusing on key horizontal issues, for example in circumstances where notification requirements and information exchange with all affected EU Member States cannot be ensured for third-country CCP resolution colleges.

The wider scope of authorities should be defined based on where the CCP is systemically important. Authorities wishing to participate in such expanded cooperation arrangements should communicate their reasoned request to the CCP resolution authority, demonstrating the systemic importance of the CCP for their jurisdictions. The ruling on such requests should be made by the CCP resolution authority based on objectively measurable criteria that are indicated explicitly in the Proposal or the supplementing Level 2 regulations. In the event of disagreement, the right to request mediation from ESMA following a negative ruling by the CCP resolution authority might be considered. One example of such a criterion could be the significance for the EU Member State’s financial system of its domestic banking (financial) sector’s exposures to a given CCP. The ESRB would also like to advocate that these criteria consider all participants in both direct (house) clearing and indirect (client) clearing to highlight that the geography of risk related to CCPs could change substantially when all participants are considered. With the increased importance of client clearing in the EU and a few CCPs in the EU with a large share of client clearing in their total initial margin or default fund contributions, these elements could also be considered.

The ESRB welcomes the fact that the Proposal already envisages the possibility of enhanced cooperation with third-country authorities. This includes cooperation through possible involvement as observers in CCP resolution colleges²¹ and even contributions to resolution planning²². It should be ensured, however, that relevant authorities from EU Member States which according to the Proposal would not be represented in resolution colleges can have

²¹ See Article 4(4) of the Proposal.

²² See Article 15(3) of the Proposal.



interactions with the CCP resolution authority and the resolution college that are, as a minimum, more intense than those of third-country authorities. Moreover, the criteria for the inclusion of these EU authorities in resolution colleges should not be stricter than the respective criteria for third-country authorities. In general, the treatment of third countries in the Proposal should be broadly based on the equivalence rule, and it should be ensured that any rights afforded to third-country authorities, in particular with respect to their admission to resolution colleges, are reciprocated by equivalent access for EU authorities to the corresponding third-country resolution bodies.

The Proposal should also provide for regular reviews of the composition of the resolution colleges. The composition of the CCP's participants could change over time, both in terms of their geography or financial market sectors. This could be driven by the market or by changes in the central clearing landscape due to the gradual introduction of the central clearing obligation in the EU. The Proposal should therefore require regular reviews of the composition of the resolution colleges to properly reflect any changes in the geography of risks.

2.6 Cooperation with bank resolution authorities

The Proposal should further outline cooperation and coordination mechanisms between CCP resolution authorities and bank resolution authorities. CCPs have evolved to become central financial market infrastructures that concentrate risk and link large global financial institutions together. In principle, a CCP should be able to withstand the joint failure of the two clearing members to which it has the largest exposures. Consequently, it can be assumed that if a CCP enters into resolution due to default-related losses, several of its largest clearing members will be in severe distress. It is likewise plausible to assume that these large clearing members, often Global Systemically Important Institutions (GSIs), will also not be allowed to fail but will be placed into resolution as specified in the EU's Bank Recovery and Resolution Directive (BRRD). Since both the bank and CCP resolution regimes may be employed simultaneously, important coordination issues therefore arise such as the resolution authorities' powers to temporarily stay early termination rights of qualified financial contracts. Against this background, the ESRB would advocate that the cooperation and coordination mechanisms between CCP resolution authorities and bank resolution authorities be further clarified in the Proposal to avoid any narrow approach and instead to jointly agree, or at least to consult appropriately, on the best outcome for overall financial stability.

2.7 Suspension of central clearing obligation

The ESRB notes that the Proposal envisages the suspension of the central clearing obligation. The ESRB welcomes the fact that the Proposal provides for the possibility of suspending the central clearing obligation in the context of a CCP in resolution when that serves the general objective of avoiding a serious threat to financial stability. This is in line with previous ESRB opinions, advocating the swift removal or suspension of the clearing obligation for financial stability purposes²³. The ESRB would like to reiterate its previous position that it sees merit in

²³ ESRB (July 2015), ESRB Report on issues to be considered in the EMIR revision other than the efficiency of margining requirements.



broadening the scope of suspending the central clearing obligation for other purposes, as a useful additional tool to mitigate systemic risk and react quickly to severe changes in market conditions.²⁴

The Proposal should further outline the conditions for suspension. The current wording of the Proposal does not frame the process for assessing whether such a suspension is the right tool to remedy the threat to financial stability in a particular CCP failure situation. The decision to suspend the obligation in a CCP resolution context should assess the existence and availability of alternative CCPs and their availability and ability to offer the clearing service to the clearing participants of the CCP in resolution, as well as whether clearing participants (clearing members and clients) are operationally and technically able to meet – within a reasonable timeframe – all requirements (e.g. legal or operational) of those alternative CCPs. The existence of these conditions could render the suspension unnecessary.

The Proposal could be more specific about the contracts which are affected by the suspension of the clearing obligation. In theory, the suspension of the clearing obligation could be applied to new contracts or to all outstanding trades, even if already cleared. The ESRB takes the view that the Proposal should clarify that the suspension refers to new contracts only. Including already cleared contracts could undermine the operation of the CCP in resolution (as well as of any other CCP which might be considered in difficulty, e.g. due to its links with the CCP in resolution) and result in a withdrawal of necessary resolution resources. In addition, the ESRB would suggest that the Proposal emphasises that the suspension of the clearing obligation does not mean a prohibition of central clearing. Market participants could therefore still centrally clear their transactions on a voluntary basis for the duration of the suspension.

Furthermore, the Proposal should provide for the possibility to suspend the clearing obligation in response to the resolution of a third-country CCP. The resolution of a recognised third-country CCP offering services in the EU could also threaten financial stability if a significant number of EU clearing participants rely on its services or a significant amount of transactions denominated in EU currencies are settled via this CCP. It should therefore also be possible in the Proposal to trigger a suspension of the central clearing obligation in response to the resolution of such a third-country CCP.

Finally, there could be more detail on some institutional aspects with regard to the suspension of the clearing obligation. In line with its role in the original decision on suspension²⁵, the ESRB should also be consulted about any renewal of the suspension in order to assess any macroprudential aspects that could be aggravated by a prolonged suspension. Further consideration could also be given to the authorities that could ask the European Commission to temporarily suspend the clearing obligation, in particular with regard to third-country CCPs that have entered resolution. In this respect, ESMA could be granted the authority to launch the process of suspending the clearing obligation on its own initiative, after consulting the ESRB. This could also act as a safeguard if the resolution authority of an authorised CCP suffers from an inaction bias.

²⁴ ESRB (April 2017), ESRB Report on revision of European Market Infrastructure Regulation.

²⁵ See Article 80(1); subparagraphs 8-10 of the Proposal.



2.8 Conditions for public financial support

Public financial support should be a truly last resort tool, in order to fulfil the objectives of resolution and instil confidence in the effectiveness of resolution actions. Although protecting public funds is one of the objectives of resolution, the possibility that public financial support may become necessary for effective CCP resolution in order to safeguard financial stability cannot be ruled out. However, recourse to government stabilisation tools without sufficient justification or cost to stakeholders could actually have negative implications for financial stability. This is because it undermines the incentives that CCP owners or clearing participants have to contribute to default management, recovery and resolution measures. Such a situation could complicate the management of a failing CCP, possibly rendering actions ineffective, resulting in unequal contributions or increasing the losses to be absorbed by public financial support. It is crucial for incentives and for moral hazard reasons that all stakeholders know that public financial support is really only available as a last resort resolution tool, and that they cannot hold off from contributing in the hope that the State will intervene and thus allow them to avoid losses. The ESRB therefore welcomes the current wording of Article 45(1)(b), which states that "... the financial support is used as a last resort after having assessed and exploited the other resolution tools to the maximum extent ...".

The Proposal should give more guidance on the preconditions. In Article 27(2), the Proposal makes "the event of a systemic crisis" a precondition for the use of government stabilisation tools. If public financial support becomes necessary, this should at least be provided subject to a certain level of burden sharing in order to minimise the implied moral hazard and ensure that the burden is actually shared by private stakeholders in a way that further enhances their incentives for private solutions. This is in line with the concept as implemented by the EU State aid framework and the bank resolution provisions of Directive 2014/59²⁶. The ESRB is not in a position to suggest a minimum threshold for this burden sharing to be included in the Regulation. This minimum level could take the form of an obligation to use all other available write-down and loss absorption tools/resolution tools to their full potential and attribute the maximum cost possible to shareholders.

The State should recover its public financial support, to further strengthen incentives for private solutions and burden sharing. Notwithstanding the ownership stake that the State would receive for its contribution to the CCP, the Proposal should include an obligation for the State to reclaim its contribution from both shareholders and other relevant stakeholders such as clearing members over a future time horizon, in order to further discourage its use. The legislation should describe in detail the arrangements under which State support would be recouped over time. The stakeholders from whom State support is recouped should be limited to the CCP shareholders (via the profits generated by the CCP itself) and/or clearing members and their clients (via the clients' contractual arrangements with their clearing members). The mechanism could entail levies, or the creation of debt claims, or some other arrangement obliging the full repayment of the support provided to the CCP by the State.

²⁶ It should also be noted that "burden sharing" with creditors (or "own contribution") is a notion inherent in any State aid measure, pre-dating Directive 2014/59. However, Directive 2014/59 requires a defined minimum level of burden sharing before States aid is considered.



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