

Are CCPs the new “Too Big To Fail” ?

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Introduction:

French Resolution Authority and CCP resolution

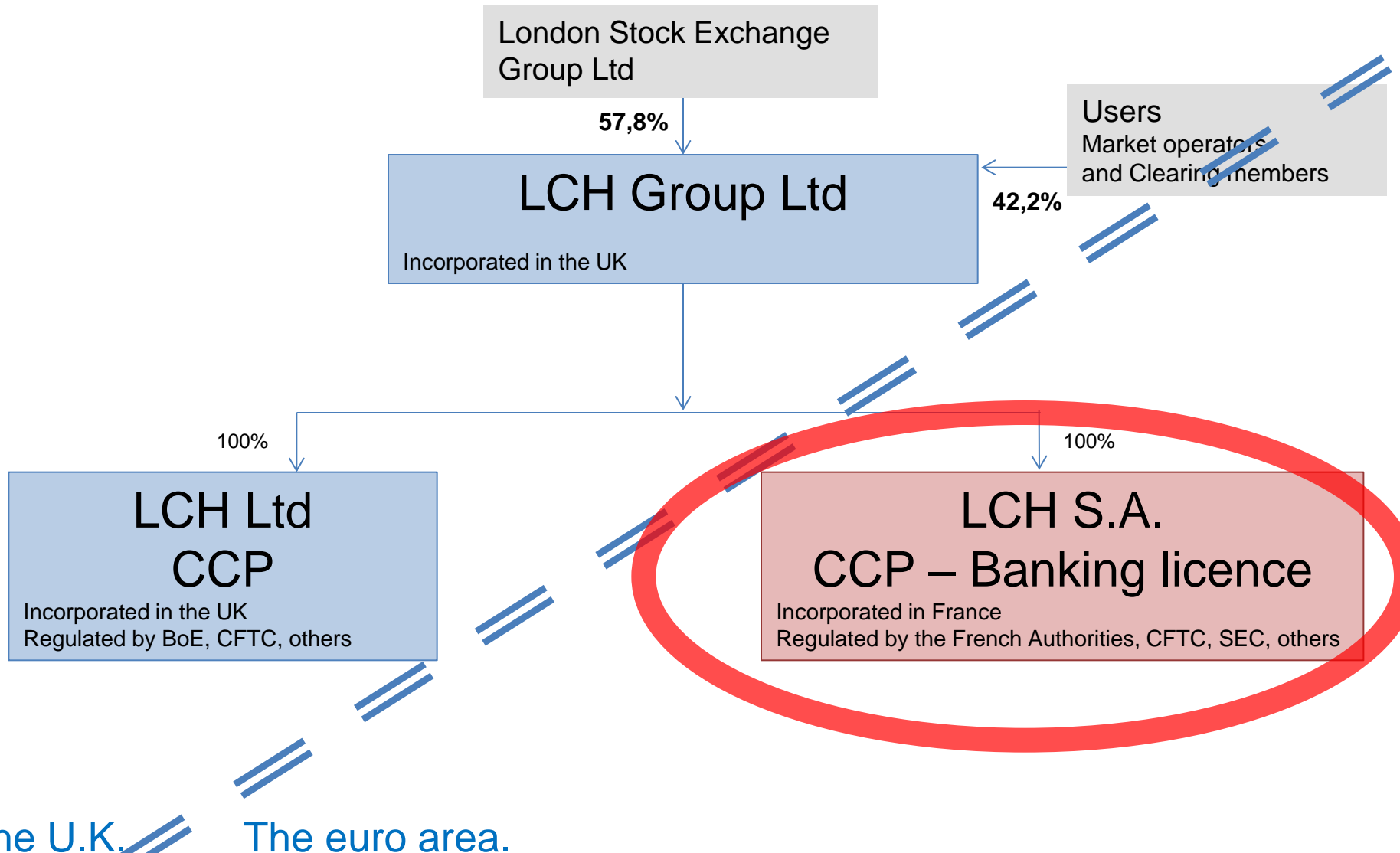
□ Practical experience: banking resolution (4 G-SIBs) since 2012

- Served as an inspiration to develop a CCP resolution regime...
- ...while being **aware of differences** (risks, financial resources, business model...)

□ On the French side, specific institutional choices have been made :

- LCH S.A, the French CCP, is **licensed as a credit institution** in France.
 - ⇒ As a credit institution, LCH S.A falls under the scope of the BRRD.
 - ⇒ So far the resolution authority has worked on the basis of the BRRD.
 - ⇒ Some tools in the BRRD could be applied in case of resolution of a CCP but additional tools are needed due to the specific business model of CCPs
 - ⇒ Both the resolution authority and LCH Group are supporters of an EU regulation given the specificities of a CCP business as opposed to banking business.
 - ⇒ A resolution Board composed of the Head of Banking Supervision, Head of Central Bank, Head of Financial Markets Authority, Head of Treasury

LCH S.A.: a CCP within a global group of CCPs



Resolution of CCPs

1. General context
2. From Stress, Recovery, Early intervention... to Resolution
3. Resolution tools
4. Timing of entry in resolution
5. Crisis management groups and cooperation
6. Cross-border issues/ Legal issues

1. General context

CCP resolution at the crossroad of 2 post-crisis global regulatory initiatives:

Improving over-the-counter derivatives markets

- **2009, G20 Pittsburgh Summit:** standardized OTC derivative contracts should be cleared through central counterparties by end-2012.

Addressing cross-border resolutions of systemically important financial institutions

- **2011, G20 Cannes Summit:** endorsement of the FSB « **Key Attributes** », which set out the core elements that are necessary for an effective resolution regime.
- **2014,** adoption of additional guidance elaborating the **KAs for financial market infrastructures.**

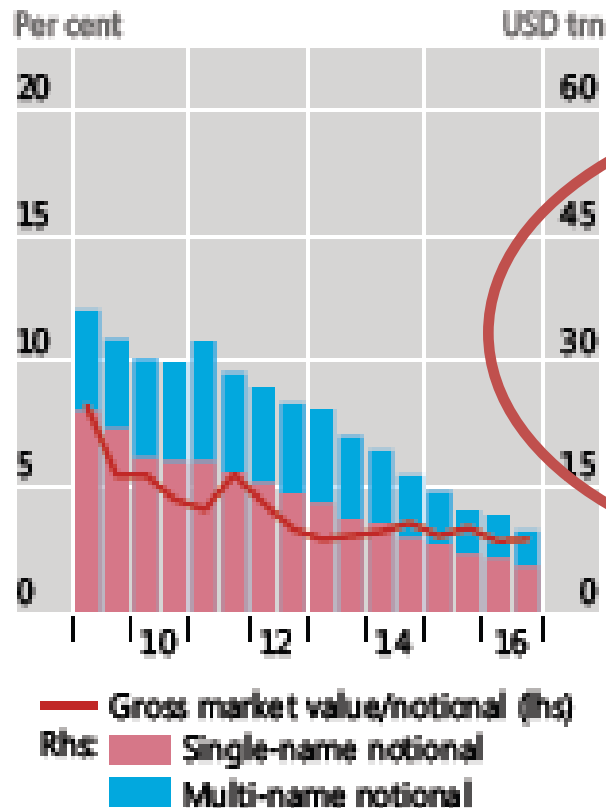
Consequence: growth of CCPs market shares

(source: BIS , OTC derivatives statistics at end-December 2016, May 2017)

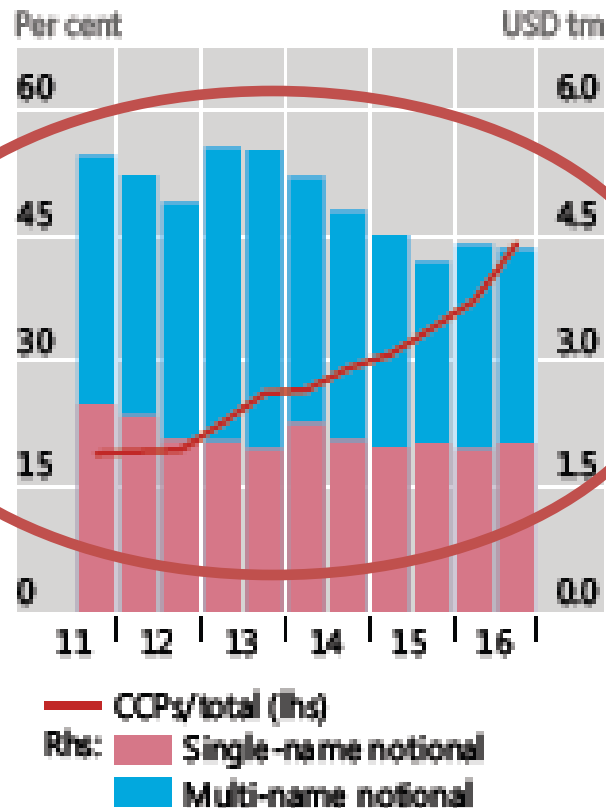
Graph A6

Credit default swaps¹

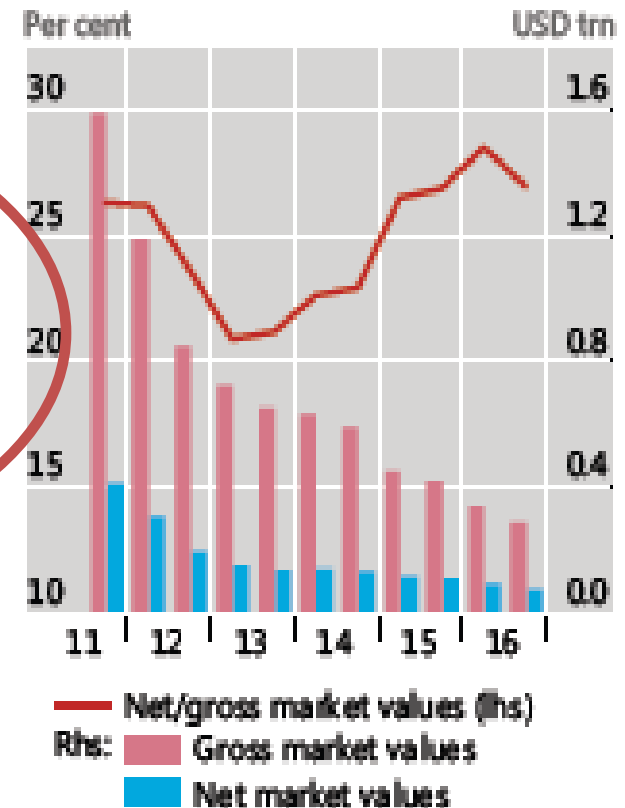
Notional principal



Notional principal with central counterparties (CCPs)



Impact of netting



Further information on the BIS derivatives statistics is available at www.bis.org/statistics/derstats.htm.

¹ At half-year end (end-June and end-December). Amounts denominated in currencies other than the US dollar are converted to US dollars at the exchange rate prevailing on the reference date.

Another consequence: need for consistent regulatory initiatives on CCP resolution :

- **At international level, parallel work programs on Recovery and Resolution of CCPs :**
 - CCP recovery and resolution plans share the key objective of maintaining financial stability through the continued provision of critical CCP services (*Recovery guidance*, §2.1.2 and KA, *FMI Annex*, §1.1)
 - **BCBS, CPMI, FSB and IOSCO established a joint CCP workplan in 2015 to coordinate their respective international policy work** aimed at enhancing the resilience, recovery planning and resolvability of CCPs.

- **In this context, FSB *Guidance on CCP Resolution and Resolution Planning* published in July 2017. Two public consultations prior to the finalization of this first FSB Guidance on the subject:**
 - On 16 August 2016, the FSB published a discussion note on *Essential Aspects of CCP Resolution Planning* that sought comments on aspects of central counterparty (CCP) resolution that are considered core to the design of effective resolution strategies.
 - On 1 February 2017 the FSB published a consultation draft *Guidance on Central Counterparty Resolution and Resolution Planning*. Interested parties were invited to provide written comments by 13 March 2017

EC proposal for a European Regulation

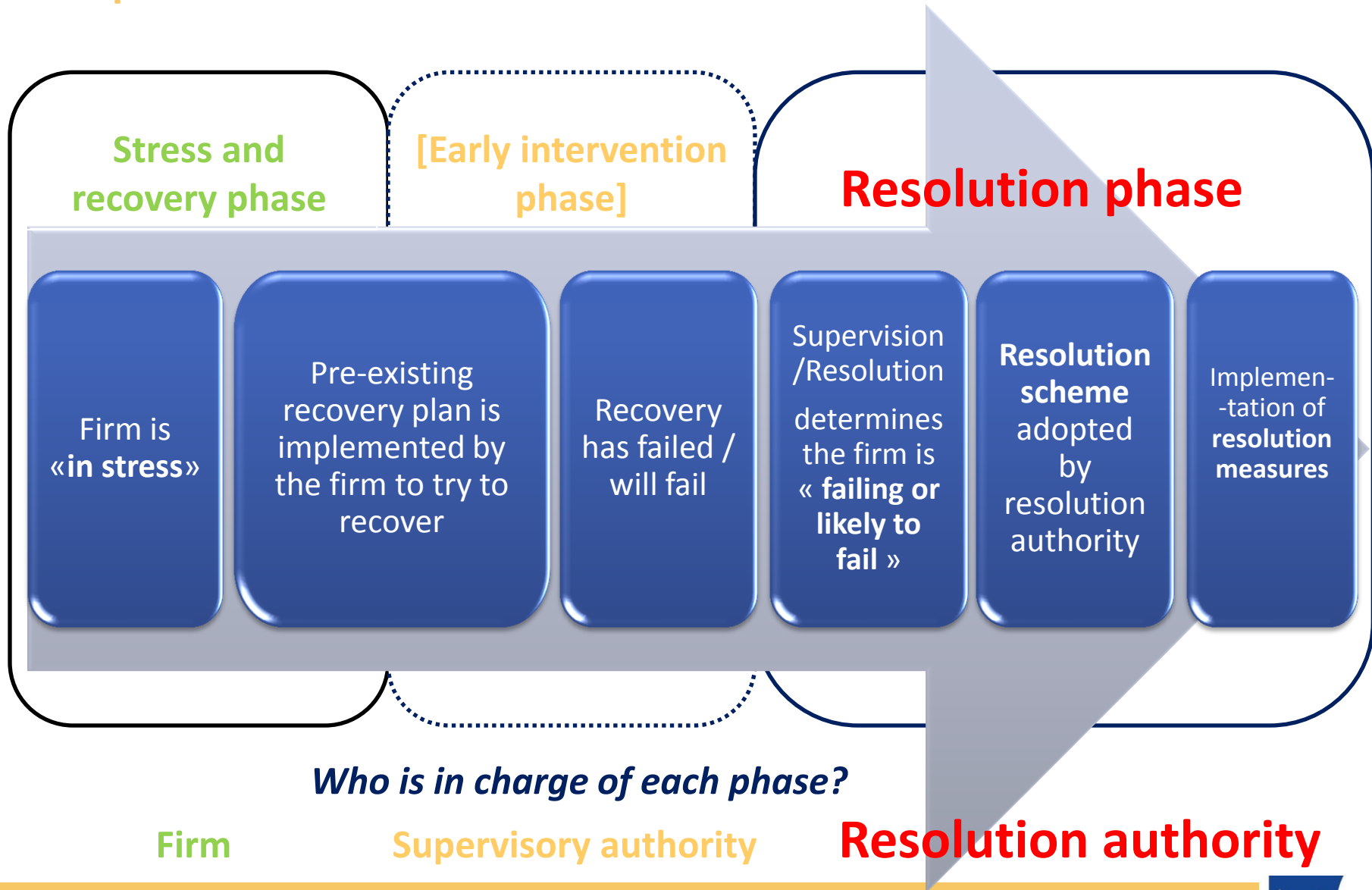
- **In Europe**, European Commission proposal for a Regulation on the recovery and resolution of CCPs published in November 2016.
 - **Public consultation** carried out by the EC between October and December 2012.
- **The European Regulation on resolution of CCPs aims at consistency with the FSB Guidance on CCP Resolution and Resolution Planning:**
 - Negotiations only started when a consensus had been reached at the international level on the main points of debate on the resolution of CCPs.
 - The European regulation will only be adopted when both Guidances on Recovery and Resolution are finalized. This will permit consistency between these sets of texts.

✍ In France, the consistency between the FSB international Guidance and the European Regulation is fundamental and of particular interest:

The French CCP, LCH.SA, is the euro-area leg of a global group of CCPs, with another leg in the UK.

In a Brexit context, consistency between the two texts should facilitate cross-border co-operation between authorities in the European Union and in the U.K. And, possibly, mutual recognition of resolution measures.

2. From Stress, Recovery, Early intervention... to Resolution



2. Articulation recovery and resolution

□ *Different persons in charge of different steps...*

Recovery: “Actions of an FMI, consistent with its rules, procedures and other ex ante contractual arrangements, to address any uncovered loss, liquidity shortfall, or capital inadequacy whether arising from a participant default or other causes (such as business, operational or structural weaknesses) including actions to replenish any depleted financial resources or liquidity arrangements as necessary to restore and maintain the FMI’s viability as a going concern.” (*CPMI-IOSCO Recovery guidance, 2014, §1.1.1*)

Resolution: “Exercise of resolution powers by a resolution authority in respect of a financial institution that meets the conditions for entry into resolution, with the aim of achieving the statutory objectives of resolution.” (*FSB Key Attributes, FMI Annex, 2014*)

- ✎ The main difference is that **recovery is carried out by the CCP**, under the oversight of that implementation by the relevant regulatory, supervisory and/or oversight authorities, consistent with their respective responsibilities,
- ✎ while **resolution is carried out by a public/resolution authority**, either directly or through a special administrator, conservator, receiver or other official with similar functions.

2. Articulation recovery and resolution

□ *...But in practice, there are strong interactions given the specific business model of CCPs:*

- **The CCP's recovery plan**, including the comprehensive allocation of financial losses and replenishment of the CCP's financial resources and capital, is a central piece not only in recovery but also in resolution:
 - *FSB Key Attributes*, in its *FMI Annex*: refers to the allocation rules and procedures of the CCP with respect to a resolution authority's powers, planning, and actions: such rules and procedures are important elements to consider when designing effective resolution planning for CCPs.
 - *CCP Resolution Guidance*: **“Given the close relationship between recovery and resolution, the development of the resolution plan should start with the CCP's recovery plan.”**

- **Time of entry into resolution:**
 - *CCP Resolution Guidance* states that a “resolution authority (...) should have the power and practical arrangements **to place a CCP into resolution promptly and if necessary prior to the end of the CCP's existing recovery and loss allocation arrangements.**”

- **Recovery and resolution tools:**
 - *CCP Resolution Guidance* states that there is a **“presumption that the resolution authority continues to follow the steps and processes under the CCP's rules and arrangements”**.
 - This results from need to strike a balance between (1) the need to preserve some flexibility in the hands of the RA and (2) the need for participants to be able to measure their exposure to the CCP.
 - The **NCWO safeguard** also illustrates the strong link between recovery and resolution.

3. Resolution tools and powers

- ❑ Resolution authorities are already able **under BRRD** to apply **4 resolution tools** and exercise several **resolution powers** on a credit institution:

4 Resolution tools

- Sale of business
- Bridge institution
- Asset separation (this tool will be applied only together with another resolution tool)
- Bail-in / write-down and conversion of capital instruments (WDCI)

Resolution powers (among others)

- Take control of the institution under resolution
- Transfer shares and other instruments of ownership
- Remove or replace the management body and senior management

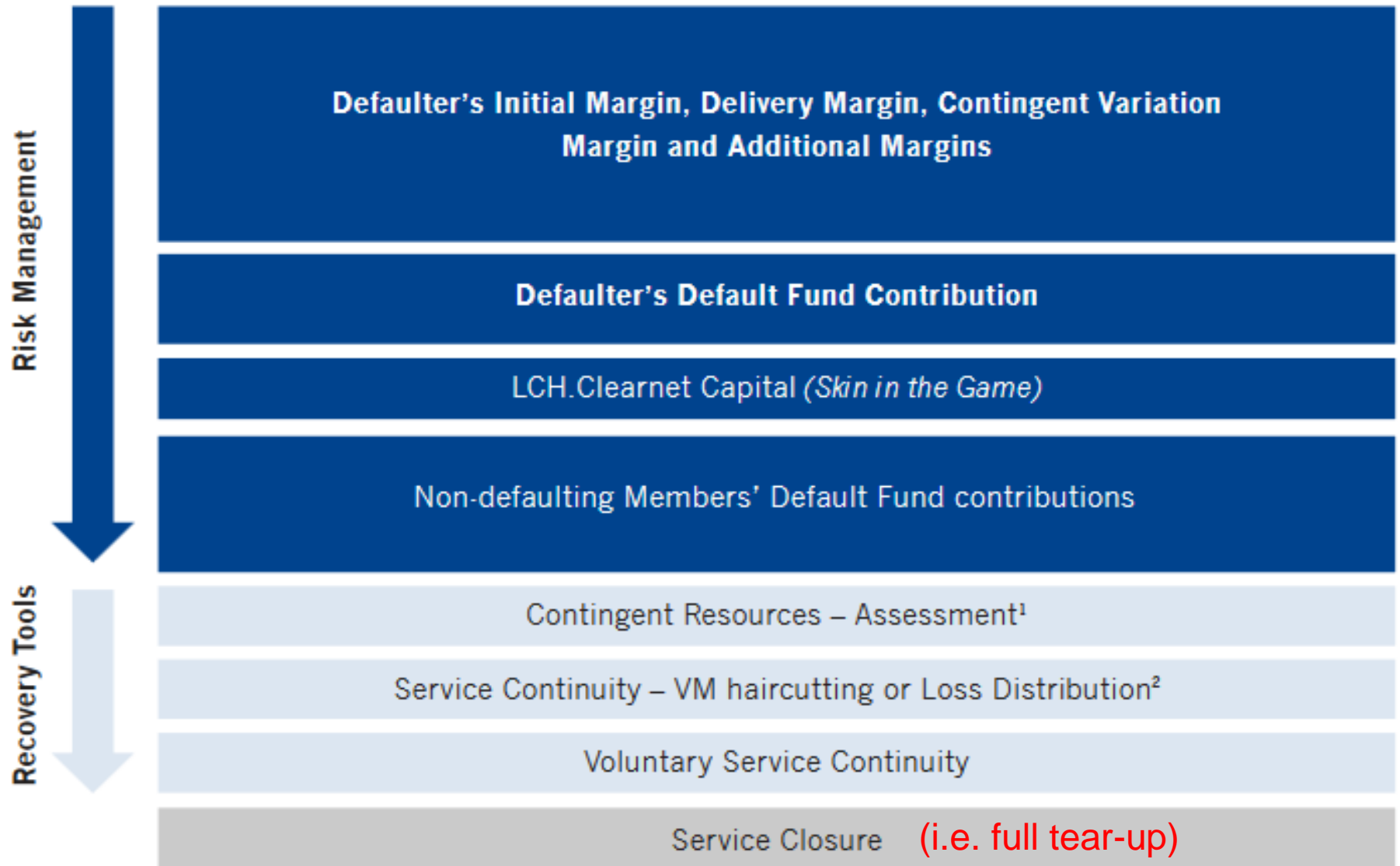
3. Resolution tools and powers

- ❑ But under Art. 28 of the proposed EU Regulation, **specific tools for CCP resolution** are recognised :
 - ✓ « **Position allocation tools** » (i.e. tools for re-matching the book):
 - ❑ “Termination of contracts – partial of full” (Art. 29, tear up)
 - ✓ « **Loss allocation tools** »:
 - ❑ “Reduction of the value of any gains payable by the CCP to non-defaulting clearing members” (Art. 30, VMGH)
 - ❑ “Resolution cash call” (Art. 31)

Some resolutions tools are mirrored in the CCP Rules, and can also be implemented by the CCP as part of its recovery plan...

- E.g.:
 - cash calls/assessments,
 - (partial) tear up,
 - (capped) variation margin haircuts.
-
- “The resolution authority should have **the power to enforce any outstanding contractual rights and obligations of the CCP (...)** where they have not been already applied exhaustively by the CCP prior to resolution.” (*FSB Guidance*)
 - There should be “a presumption that the resolution authority continues to follow the steps and processes under the CCP’s rules and arrangements where it intervenes before these have been **exhausted**, as these will be known to the CCP, its participants and the markets served by the CCP.” (*FSB Guidance*)

Example: LCH S.A.'s waterfall and recovery tools



¹ Callable up to the value of each member's Default Fund contribution at the time of the default.

² The resources available in the service continuity phase are determined by the LCH.Clearnet Rulebooks.

...However, the intervention of the resolution authority has its own added value:

➤ **Added value of the intervention of the resolution authority:**

- ✓ **Impartiality**
- ✓ **Credibility (as opposed to a private firm in stress)**
- ✓ **Additional tools and financial resources**

➤ **The RA may implement additional tools which are specifically reserved to it:**

FSB Guidance states that resolution authorities should have other powers that may be necessary to carry out an orderly resolution of a CCP, including powers and tools to:

- ✓ **Wind-down operations** not judged to be critical functions;
 - ✓ **Write down** (fully or partially) **the equity of the CCP**;
 - ✓ **Convert unsecured liabilities into equity** or other instruments of ownership;
 - ✓ **Require (capped) additional 'resolution cash calls' from participants** to the CCP.
 - ✓ **Execute (uncapped) VMGH**
- As part of its capacity to refrain from enforcing the CCP rules and arrangements, the RA may, on a discretionary basis, decide to only apply partly the powers provided for under the CCP Rules

Safeguards for participants, equity holders, and creditors:

➤ The « No creditor worse-off » principle (*FSB Guidance, §5*):

CCP participants, equity holders and creditors, should have a right to compensation

- if and to the extent that the **resolution authority deviates in resolution from the loss allocation mechanisms under the CCP's rules and arrangements;**
- where they do not receive in resolution at a minimum **what they would have received if**, instead of resolution, **the CCP had been liquidated** under the applicable insolvency law.

➤ **Compensation in return for contributions to CCP resolution** (*FSB Guidance, §2.15*):

- The resolution authority should 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**, for both default-related and non-default related loss scenarios.
- Means of compensation : for instance, by providing appropriate amounts of equity or other instruments of ownership or debt instruments convertible into equity to them. The resolution authority may also award to them claims on the parent of the group to which the CCP that entered resolution is affiliated, subject to the consent of the parent.

➤ **Non discrimination** (based on nationality, or category of the participant/creditor, etc)

➤ **Transparency of the resolution strategy** (as far as it contributes to fostering positive incentives)

Certain tools have been discarded or are not preferred tools according to the international / EU texts:

❑ TLAC / MREL

- ⇒ Not adequate to the business model of a CCP (CCPs do not issues debt; cash invested in...?)

❑ Prefunded resources earmarked for resolution

- ⇒ Practical problems: e.g. calculation method?
- ⇒ Who would contribute? Only CMs? their clients? asset management firms? the entire financial sector (incl. foreign firms)?

❑ No (European) Resolution Fund for CCPs

- ⇒ Many, many technical, practical and political problems (same as above)
- ⇒ Who would be the European lender of last resort for the resolution of a systemic CCP?
- ⇒ Are you ready to grant a veto power on the rescue of your financial marketplace?

❑ Initial Margin Haircutting

- ⇒ Protection of clients
- ⇒ This instrument was not supported at international level

4. Timing of entry in resolution

- ❑ **Timing of entry is closely related to resolution scenarios:**

- ❑ **Default losses (DL) scenario:**
 - 'Financial armageddon': 2-GSIBs in resolution; their resolutions are failing

- ❑ **Non default losses (NDL) scenarios:**
 - Have been under-estimated until recently.
 - A typology of NDL scenarios (source: LCH paper):
 - Investment Losses arising from the activity of margin investment.
 - Operational Risk Events.
 - Legal/Regulatory Risk.
 - Liquidity Shortfalls arising when a clearing member defaults.
 - Failure of a Custodian or Settlement Platform.
 - Failure of a Settlement Bank or a Concentration Bank.
 - Actions of 3rd parties.
 - Non-performance of Vendors, Service Providers and IT Suppliers.

4. Timing of entry in resolution

□ ***What objectives justify the intervention of the resolution authority?***

KAs FMI Annex provides that an effective resolution regime for CCPs should:

- **Pursue financial stability;**
- **Allow for the continuity of critical FMI functions**, either by restoring the ability of the FMI to perform those functions as a going concern or ensuring the performance of those functions by another entity or arrangement coupled with the orderly wind-down of the FMI in resolution;
- **without exposing taxpayers to loss.**

□ ***Hence, there is a need to strike the balance between contradictory objectives:***

Both sets of guidance acknowledge the need to strike a balance between:

- **The need for the resolution authority to preserve some flexibility in extreme scenarios in order to handle the situation;**
- **In a DL scenario, if the resolution authority steps in too late, it will have no financial resources available (Default Fund depleted, surviving clearing members not strong enough to contribute or having left the CCP)**
- **The need for participants to be able to measure, manage and control their exposures to losses or liquidity shortfalls.**

How to strike the balance ?

4. Timing of entry in resolution

➤ On the one hand, **PREDICTABILITY** is a principle:

- *FMI Annex, §4.3, (i)* : RA should intervene in circumstances in which “**the recovery measures available to the CCP (...) have been exhausted and failed to return the CCP to viability.**”
- *FSB Resolution guidance (§3)* : “There should be a **presumption** that the resolution authority continues to follow the steps and processes under the CCP’s rules and arrangements.”

➤ On the other hand, **FLEXIBILITY** responds to the pragmatic need for rapid and effective action under scenarios without any precedent :

- *FMI Annex, §4.3, (ii)* : RA can intervene in circumstances in which the recovery measures available to the CCP are either “**not reasonably likely to return the CCP to viability**” or “**likely to compromise financial stability**”.
- *FSB Guidance (§3)* : The RA should have the power to place a CCP into resolution (...) if necessary prior to the end of the CCP’s existing recovery and loss allocation arrangements where recovery measures available to the CCP “**are not being implemented in a timely manner**”, or “**are not reasonably likely to return the CCP to viability within the timeframe required to enable continued compliance with applicable legal and regulatory requirements**”, or “**are likely to compromise financial stability**”.

☞ **To remember : possibility for the RA to initiate resolution before the recovery plan has been fully implemented by the CCP.**

4. Timing of entry in resolution

□ **TRANSPARENCY**, the FSB Guidance sets out potential indicators that may inform a determination of whether to place a CCP into resolution:

➤ **For default losses (non exhaustive):**

- i. the CCP is or will likely be unable to return to a matched book, or can only do so by actions that would require resources in excess of its available prefunded and committed financial resources, compromise financial stability or by actions that create significant, unpredictable exposures for the CCP's participants;
- ii. the CCP is or is likely to be unable to cover losses, (...) or can only cover losses with actions that would create significant, unpredictable losses for the CCP's participants;
- iii. the CCP is unable or likely to be unable to replenish its financial resources within a reasonable time frame to a level that can deliver continuity of critical functions and meet regulatory compliance;
- iv. the management of the CCP is not implementing in a timely manner the default management processes or recovery actions creating material risk to the continuity of the critical functions.

➤ **For non-default losses (non exhaustive):**

- i. the CCP's capital is or is likely to be exhausted or severely depleted below regulatory requirements (...) and the current owners are unwilling or unable to recapitalize the CCP;
- ii. the CCP can only cover losses with actions that would create significant, unpredictable losses for its participants;
- iii. the CCP fails or is expected to fail to comply with other regulatory requirements for authorization and this threatens financial stability, and cannot be addressed by supervisory actions.

5. CMGs and cooperation

□ Both FSB Guidance and EU Regulation stress the **need for cooperation among different authorities (banking supervision, market authorities, resolution, central banks, overseers of CSDs), from different countries:**

➤ One main objective: to facilitate effective crisis preparedness

- *The CPMI-IOSCO PFMI*s stress that :
 - Relevant authorities should “cooperate **both domestically and internationally** (...) in order to support each other in fulfilling their respective mandates with respect to FMIs.”
 - Such cooperation needs to be effective “**in normal circumstances and (...) during periods of market stress, crisis situations, and the potential recovery, wind-down, or resolution of an FMI.**”
- *FSB Guidance (§3.1)* states that “timely and frequent communication among supervisory, oversight and resolution authorities about a CCP’s condition and risks should facilitate effective **crisis preparedness well in advance** of any specific issues the CCP may encounter.”

➤ One privileged forum for cooperation: the CMGs

- *KAs FMI Annex (§9.1)* calls for “**CCPs that are systemically important in more than one jurisdiction to have Crisis Management Groups.**”
- *ReSG, Resolution Workplan 2016* : “**By the end of 2016, CMGs should be established for CCPs that are systemically important in more than one jurisdiction.**”

6. Cross-border issues/ Legal issues

- ❑ ***The RA and the CMG should identify any challenges to the enforceability/effectiveness of resolution actions that may arise in a cross-border context...***
 - This assessment is part of resolution planning and **resolvability assessment**.
 - **Some examples** of cross-border specific “obstacles to resolvability” are provided for in the FSB Guidance:
 - **interoperating arrangements** and **cross-margining** with CCPs in other jurisdictions;
 - **critical services and functions** provided by entities that are located in other jurisdictions;
 - **participants** that are incorporated in other jurisdictions;
 - the use of foreign **custodians, payment banks or settlement banks**;
 - **custodian relationships or collateral arrangements** governed by foreign law.

- ❑ ***...and address those obstacles, through:***
 - **arrangements for cooperation and coordination of resolution proceedings;**
 - **procedures for supportive actions from relevant authorities in other jurisdictions;**
 - ensuring that, where needed, **resolution actions are incorporated in the CCP’s rules and arrangements** or in other contractual agreements to give effect to or support the enforceability of such actions on a cross-border basis.

6. Cross-border issues/ Legal issues

- The existing E.U legal framework provides statutory support to the cross-border recognition of financial transactions/collateral within the E.U.
- CCPs under EMIR are protected by finality of instructions and settlement
- « Financial Collateral » Directive n°2002/47:
 - Refers to CCPs (covered by the scope of application of the Directive)
 - **Implemented in practice: LCH S.A. Rules**
 - **Covers cross-border insolvency but does not cover resolution → need for a specific EU regime ensuring mutual recognition of resolution measures.**

Reminder: the European cross-border recognition regime for resolution actions *(as set out in CCP R&RR, but already effective for banks under BRRD)*

- Under article 75 on *Recognition and enforcement of third-country resolution proceedings*, national authorities shall **recognize third-country resolution proceedings** relating to a third-country CCP in certain cases and **ensure the enforcement of these proceedings**, and shall **have the power to exercise resolution powers in relation to a third-country CCP** in relation to assets that are located in their Member State or governed by the law of their Member State.
- Under article 77 on *Cooperation with third-country authorities*, resolution authorities shall conclude **cooperation arrangements** with certain relevant third-country authorities, to establish processes for information sharing and for the carrying out of certain tasks.



Questions?