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RESPONSE TO THE CPSS-IOSCO CONSULTATIVE REPORT ENTITLED "RECOVERY AND RESOLUTION OF FINANCIAL MARKET INFRASTRUCTURES"

EACH, the European Association of Central Counterparty Clearing Houses, welcomes the opportunity to respond to the CPSS-IOSCO Consultative report on Recovery and Resolution of Financial Market Infrastructures ("the Report").

EACH welcomes the differentiated approach for Financial Market Infrastructures (FMIs), as in our view the recovery and resolution approach for banks cannot and should not be adapted to FMIs.

Furthermore EACH believes that every CCP possesses an individual recovery regime for member default risks in the form of a default waterfall, which was developed to match the specific business and circumstances of that CCP and its participants.

EACH understands resolution as a measure which occurs before an insolvency and which is implemented with regulatory assistance. EACH is of the opinion, that resolution depends strongly on the local insolvency law and therefore no "one size fits all" solution is given (e.g. a CCP holding a banking licence gets exemption from banking regulation on resolution in favour of regulation of FMI resolution). Provisions, which are enforceable in one market under recovery, can be implemented in another market only under resolution or insolvency. Therefore EACH asks for individual solutions.

EACH is furthermore of the opinion that the resolution authority must be a part of the same organisation as the supervisory authority. Furthermore EACH will only make detailed remarks on the recovery and not the resolution measures. EACH considers that when the resolution phase is entered, the CCP is no longer an independent stakeholder in the process. This section should be left to market participants and regulatory authorities to comment. Having said that, EACH does have a concern that the design of certain resolution approaches may have a significant negative impact on a CCP which is in its "business as usual" mode of operation. EACH's specific concerns are as follows:

a) *Policy Tensions with CCP Operating Standards:*

The proposed resolution arrangements contain some inherent tensions with the operating standards which have been promulgated for CCPs internationally by CPSS-IOSCO and within the EU and, depending on the detailed design of the resolution arrangements, they may create direct conflicts with those operating standards. If the resolution arrangements took the form of "bail-in" powers

whereby some or all of the solvent clearing members' initial and variation margin would be exchanged for equity in the failing CCP in circumstances where the CCP had insufficient resources to manage the default of other clearing members (as has been suggested in the Report), this would directly contradict key provisions of EMIR. For instance, EMIR stipulates that "a CCP shall not use the margins posted by non-defaulting clearing members to cover the losses resulting from the default of another clearing member"[1] and a CCP shall not "expose the non-defaulting clearing members to losses that they cannot anticipate or control"[2]. This type of bail-in approach would also require clearing members to replenish their initial margin which may, in turn, trigger further defaults should clearing members or their clients being unable to do so. However it might be intended that resolution powers by an incoming resolution authority may explicitly over-ride CCP rules. This enables the CCP to be compliant with the regulation while under resolution the status quo is replaced by emergency powers of a resolution authority.

b) *Shareholder and Clearing Member Dis-incentives:*

Exposing clearing members and CCP shareholders to unquantifiable – and potentially unlimited and open-ended - contingent liabilities by requiring them to restore the CCP to financial viability would be a significant dis-incentive to their willingness to continue to act in those capacities. The business case for a firm maintaining clearing membership is already under strain given the increased costs and reduced revenue streams implicit in post-crisis regulatory requirements, such as the EMIR segregation and margining provisions. Adding an unlimited contingent liability, requiring a clearing member to cover losses that it is unable to control or quantify, is likely to reduce further the pool of firms which are willing to continue to be clearing members. This, in turn, would lead to a concentration of risk in a smaller number of clearing members, which is likely to be negative in relation to systemic risk management. It would also leave regulators of clearing members with the issue of whether they should establish capital requirements on the largely unquantifiable additional contingent exposures. To date most regulators of clearing members have taken the view that those firms' exposures to CCPs must be capped and quantifiable.

[1] EMIR, Article 45(4) (Default waterfall).

[2] EMIR, Article 48(2) (Default procedures).

Please find below detailed answers to some questions raised. Some EACH members will respond separately to further questions raised:

Chapter 3 – Recovery and resolution approaches for different types of FMI

FMIs that do not take on credit risk

Q1: In what circumstances and for what types of FMI can a statutory management, administration or conservatorship offer an appropriate process within which to ensure a continuity of critical services?

A: EACH assumes that CCPs would fall under this regulation as part of their function and as a protection for the market participants.

EACH notes that a CCP makes use of other FMIs such as settlement platforms and custodians. In order to avoid that the failure of any of these institutions would have an impact on the functioning of the CCP, these institutions should also be covered by this regulation.

Q2: Are there powers beyond those of a standard insolvency practitioner that a statutory manager, administrator or conservator would require in these circumstances?

A: In this context two cases, where specific powers may be required, have to be discussed:

"Avoid the exit of a clearing member"

If powers will be given to resolution authorities to avoid the exit of clearing members in case of a CCP wind down, the resolution should depend on the type of products cleared by the CCP. In the case of cash traded instruments the trade flow could be moved very quickly from one CCP to another while for OTC and listed derivatives or repo transactions clearing members would have fewer possibilities to move to another CCP quickly.

"Start of CCP wind down"

The timing of the recovery and resolution phase is essential. In practice, there should be a controlled 'hand-over' from the recovery to the resolution phase. EACH does not believe that resolution legislation should attempt to define that hand-over boundary. On the basis of the necessary dialogue between CCPs and regulators and resolution authorities, the parties should establish a common understanding of boundary lines and indicators of when such lines are being approached. A close contact and dialogue between those parties is essential in relation to recovery actions by CCPs.

In the recovery phase a CCP would handle the issue within its own rules, while in a resolution phase resolution authorities could use specific resolution measures, which are not known in advance.

EACH considers that sufficient time should be allowed under the recovery phase to put all reasonable efforts in place to enable to recover the business. The start-up of a resolution phase should be a last resort measure. A wide range of potential powers of recovery would reduce the likelihood that a resolution phase is started.

EACH would like to know, whether regulators or the CCP itself should start the resolution phase. Both solutions have pro and cons. A CCP risk manager can evaluate the sufficiency of financial resources. Regulators may need to be very close to the recovery process in order to make an assessment of the viability of the CCP. There is no clear preference within EACH for either solution.

FMIs that take on credit risk - Recovery

Q3: Is tear-up an appropriate loss allocation arrangement prior to resolution of a CCP? If so, in what circumstances?

A: It is difficult to give a definite answer to this question.

On one hand a CCP should, in addition to margining and guarantee fund arrangements, put in place recovery arrangements which manage all plausible failures. Such recovery arrangements are likely to include a range of measures, culminating potentially in the tear-up of contracts. Full or partial tear-up measures may be legitimate recovery provisions, providing a means for the CCP to resume business, as recognised in paragraph 3.14 of the consultative report.

On the other a full tear-up of contracts would constitute a discontinuity of clearing services and would therefore not qualify as a recovery measure which would achieve the objective of ensuring continuity of critical services. Having said that, if there is no other CCP which is willing or able to assume that business (e.g. because other CCPs are also affected by the severe financial stress which has impacted the CCP in question), a full tear-up may be the only viable solution. A partial tear-up of contracts held by the defaulting member, after all regular measures to resolve the situation including an auction have been taken, could qualify as recovery measure but may have a disproportional impact on specific clearing members being the original counterparty or active in the same product/contract range as the defaulting member.

However, a partial tear-up (e.g. applied to a particular product set) can be a very useful method by which to isolate losses incurred within a part of the cleared spectrum at a particular CCP, as opposed to a spill-over of the losses to other market segments. It clearly rebalances the CCP's open positions, and allocates the losses to the participants holding the now problematic contracts. This device is useful in circumstances where a particular market or asset class is no longer viable, as demonstrated by the unwillingness of the membership to provide resources needed to meet the auction discounts or price moves. However this measure might be part of a recovery regime in one market and might be fully supported by the clearing members. In other markets such a measure might have to be subject to a resolution

regime.

EACH also noted that a tear-up of contracts would have important consequences for an interoperability link between CCPs and this should be considered in the design of the loss allocation mechanism.

Other methods like non-competitive allocation may also qualify fair allocation methods, but the potential issues for clearing members relating to receiving a position, which they have never traded, should be dealt with. The most important element is that the design of the recovery measures should be linked to the profile of the cleared market, as stated before there is no "one size fits all" solution.

EACH agrees that the last resort mechanism should not lead to a better result for clearing members than participating in the auction as this could create an incentive to not bid in the auction and force the CCP in the resolution phase.

Q4: To what extent should the possibility of a tear-up in recovery be articulated in ex ante rules?

A: A partial or full termination of a sub-set or entire asset class should be clearly and publicly stated for all CCPs, so as to create transparency by informing participants of the possible consequences and properties of their contracts so as to instill both market discipline and prevent any surprises if the CCP faces extremely adverse market conditions.

All recovery measures should be included in the rulebooks of the CCPs while regulators will determine the resolution measures.

EACH furthermore agrees that there is no preferred measure as this depends on the type of the product and the relevant waterfall. These mechanisms should be designed by the relevant CCP in consultation with their risk committee(s).

The recovery measures should besides the treatment of clearing members also specifically lay out the treatment of (individually) segregated clients and linked CCPs.

Q5: Should there be a limit to the number of contracts that are eligible for tear-up?

A: There should be no limit, especially if the CCP does not clarify what other methods are to be employed to appropriately tackle problems. The reasons for not limiting the number are that doing so may:

1) Force an uneven distribution of the tear-up

2) Not ensure a balanced CCP. The CCPs should define what aggregations of contracts are torn up in the event of a decisive and irreversible market failure.

Q6: How should the appropriate haircuts be determined?

A: The haircut method should be chosen to be the most equitable and least disruptive.

FMIs that take on credit risk - Resolution

Q7: What qualitative or quantitative indicators of non-viability should be used in determining the trigger for resolution for different types of FMI?

A: As set out in our response to question 3, EACH believes that each CCP should, in addition to margining and guarantee fund arrangements, put in place recovery arrangements which manage all plausible failures. It is essential that resolution arrangements fully take into account such recovery arrangements. In particular the trigger for resolution should clearly state that a CCP will only be placed into resolution if its agreed recovery arrangements have failed or are likely to fail. Otherwise, the threat of resolution will act to diminish the effectiveness of recovery arrangements.

The final trigger for entry into resolution or the involvement of a resolution authority must be no earlier than the contractually available resources, outside of operational capital, of the CCP being exhausted. The later this is done, the more likely it will be for a resolution authority to institute a temporary stay on contracts to permit time to assess the situation.

So a potential rule to start the resolution phase is the imminent and inevitable depletion of financial resources and powers of assessment available to the CCP. EACH notes that the indicators for this are:

- Depletion of capital and no support from shareholders to replenish
- Lack of liquidity to perform daily activities.

Furthermore on the basis of the necessary dialogue between CCPs and regulators and resolution authorities, the parties should establish a common understanding of indicators of determining the trigger for resolution.

Furthermore EACH would like to comment on Article 3.23 of the report:

"In the case of a CCP, there is also an increased risk that if some of the participants exercise early termination rights, the CCP may no longer have a "matched book".

EACH would like to highlight, that all CCPs have rules whereby members can only exit in the case of a flat book (all positions are closed). This should be clarified in the Article 3.23.

About EACH

European central counterparty clearing houses (henceforth CCPs) formed EACH in 1992. EACH's participants are senior executives specialising in clearing and risk management from European CCPs, both EU and non-EU. Increasingly, clearing activities are not restricted exclusively to exchange-traded business. EACH has an interest in ensuring that the evolving discussions on clearing and settlement in Europe and globally, are fully informed by the expertise and opinions of those responsible for providing central counterparty clearing services.

EACH has 23 members:

CC&G (Cassa di Compensazione e Garanzia S.p.A.)

CCP Austria

CME Clearing Europe Ltd

CSD and CH of Serbia

ECC (European Commodity Clearing AG)

EMCF (European Multilateral Clearing Facility)

Eurex Clearing AG

EuroCCP (European Central Counterparty Ltd)

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This document does not bind in any manner either the association or its members.

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