Eurex Clearing
Comments
to the

CPSS-IOSCO Consultative Report

"Recovery and resolution of financial market infrastructures"

September 2012

A. Introduction

Eurex Clearing is a globally leading central counterparty clearinghouse (CCP) and the largest clearinghouse in Europe. Eurex Clearing is a subsidiary of Deutsche Börse Group providing central clearing services for cash and derivatives markets both for listed as well as certain over-the-counter (OTC) financial instruments. Eurex Clearing actively contributes to market safety and integrity with state-of-the-art market infrastructure both in trading and clearing services as well as with industry leading risk management services for the derivatives industry. Customers benefit from a high-quality, cost-efficient and comprehensive trading and clearing value chain.

Eurex Clearing AG is a company incorporated in Germany and licensed as a credit institution under supervision of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) pursuant to the Banking Act (Gesetz für das Kreditwesen). The Financial Services Authority (FSA) has granted Eurex Clearing status as a Recognised Overseas Clearing House (ROCH) in the United Kingdom.

Eurex Clearing welcomes the opportunity to comment on the consultative report on "Recovery and resolution of financial market infrastructures" published by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) in July 2012.

This comment paper is arranged as follows. The first section contains our general observations on the CPSS-IOSCO consultation papers. The second section provides detailed comments on each question.

B. Comments

B 1: Summary of general observations

We acknowledge the efforts by the Committees of CPSS and IOSCO to provide a differentiated approach for Financial Market Infrastructures (FMI's), as in our view the processes and approaches for recovery and resolution should not be and could not be the same as for banks.

We understand that the target of the consultation is to evaluate a recovery and resolution approach which is applicable for all FMI's. Eurex Clearing AG (ECAG) believes that a standardized recovery and resolution approach has to take into account national legislative regimes in particular insolvency laws. CPSS / IOSCO should require, if needed, adaption of national laws.

It is necessary especially for CCP's that the rules applied are effective for all FMI's (a. take on credit risks / b. do not take on credit risks) due to the strong dependencies between each other and to avoid spill-over effects.

ECAG answered to both a.) Recovery and b.) Resolution questions, but understands that an FMI will no longer be an independent institution once entered into resolution since the resolution authority will take over responsibility for all remaining business operations until the FMI is reestablished or wound down.

ECAG believes that the responsible resolution authority, which is also in charge for the evaluation of the recovery plan, shall be a part of the supervisory authority of the respective FMI.

B 2: Detailed comments

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?

Comment:

Recovery and Resolution Plans (RRPs) should be defined for all kinds of FMIs. Each FMI should define in its RRP the concrete circumstances in which such RRP is triggered. Ideally, the FMI describes different forms of recovery or resolution whereby the respective Resolution Authority (RA) shall decide what form to apply on a case by case basis. In any case clarity regarding the responsible RA is required.

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

Comment:

When deciding on the concrete form of recovery or resolution to be chosen, it is very crucial that consequences for other (interlinked) FMIs are taken into account. Ideally, affiliated or otherwise combined FMIs are supervised by the same authority.

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

Comment:

A (partial) tear-up 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. (We assume that the resources are adequately scaled and already exhausted, or can ex ante be increased if the market or asset class in question is deemed to be salvageable.)

If only some transactions are torn-up, as opposed to a closure of the entire market, the tear-up should be conducted on a pro-rata basis, taking into account the exposure each clearing member has with respect to "the problematic transactions".

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

Comment:

A partial or full termination of a sub-set or entire asset class should be clearly and publicly stated and provided for in the relevant laws for all CCPs, so as to 1) create a level playing field across FMIs 2) to inform 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.

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

Comment:

There should be no limit, especially if the FMI 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?

Comment:

The haircut method should be chosen to be the most equitable and least disruptive. Thus, the contracts should be terminated at the last successful mark-to-market (or variation margin run). However, payment cropping or variation margin haircutting is the least preferred option to further cash calls as this will unevenly affect the subset of accounts with positive market values, and not distribute losses across the entire membership.

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

Comment:

The final trigger for entry into resolution or the involvement of a Resolution Authority must be no later than the contractually available resources, outside of operational capital, of the FMI being exhausted, e.g. if RRPs were triggered only once the FMI's equity capital was exhausted, the responsible RA would be very limited in the concrete form of recovery or resolution to choose from. The later this is done, the more likely it will be for a resolution authority to institute a temporary stay on contracts or close markets to permit time to assess the situation.

Q8: What loss allocation methods must be available to a resolution authority, and for which types of FMI? Could or should these resolution powers include tear- up, cash calls or a mandatory replenishment of default fund contributions by an FMI's direct participants? Does it make a difference if the losses are from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI)? In what circumstances, and by what methods, should losses be passed on beyond the direct participants – e.g. to the clients or FMI shareholders – in resolution?

Comment:

The RA must decide whether or not the FMI is still viable institution, or whether the FMI or the markets it supports are no longer viable. In the latter case, the RA should proceed to close down the FMI, in the most equitable and least disruptive way, preferably by way of a contract termination. In the former case, if the RA intention is to ensure continuity of the markets, then a broad set of tools must be available to collect the necessary funds to recapitalize, reestablish, temporarily fund, or otherwise

maintain the functions of the FMI. These should include: mandatory Guaranty Fund calls, bail-in of the FMI's shareholders/bondholders, non-defaulting member's collateral being haircut, haircutting payments out (such as variation margin, or other contract /trade evaluation changes), and future payments such as transaction, exposure, or simple membership fees/levies /to recoup any emergency loans).

If the FMI RRP is not caused by member default related losses, but rather other reasons such as fraud, or investment risk, then the losses should not be allocated to the membership, but only the FMI's shareholders/bondholders, retained earnings, and restrictions on future capital distribution.

Client or direct participants are difficult to include in a direct replenishment call, as they are usually not known to the FMI. In case the FMI is aware of the clients, however, it usually has established a (contractual) relationship to the clients only with limited scope and with respect to specific topics. Therefore, in general direct members should be able to choose whether they will pass on the costs of supporting the FMI onwards.

Q9: What, if any, special considerations or methods should be applied when allocating losses whose maximum value cannot be capped (e.g. when allocating potential losses that might arise from open and uncapped positions at a CCP)?

Comment:

Ideally, a CCP defines for its own resources, and what it may mutualize across its members, a finite total value of losses. This should demonstrate the strength of a particular FMI, but also explicit the point at which, beyond other voluntary or RA imposed contributions, the CCP would enter into a wind-down. If further funds or changes to the cleared contract's economics are not possible alternatives, the CCP has no choice but to tear-up, close or port the (part of) the market. This is similar to the normal credit risk of any non-risk-free counterparty, except of course that the structure and rules of CCPs make them extremely safe. However, contract termination may open up a further exposure for the affected members, but this is the case for any credit risk (although of course substantially safer given the lines of defense and other tools of a CCP).

Q10: How should equity in FMIs be treated in resolution scenarios: should it be written down in all circumstances?

Comment:

In extreme scenarios in which a RRP is triggered, all financial resources available to the FMI should be applied (including the FMI's equity capital). However, to enable the RA to choose the most appropriate form of recovery and resolution it is essential that such authority takes over control before all equity is written down. If parts of a FMI's equity are earmarked to be used once a RRP is triggered, such capital could be used by the RA to e.g. re-establish or wind-down the respective FMI.

Q11: Are there circumstances in which loss allocation in resolution should result in a different distribution of losses to losses borne in insolvency? Does it make a difference if the losses stem from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI or resulting from operational risks)?

Comment:

The loss allocation is to a large confidence level already defined in the waterfall of the CCP, and any loss distribution beyond this depends on the direction the RA takes the FMI into. For instance, if the recapitalization is repaid through a levy on clearing at the CCP then active users of the service in the future bear the costs. On the other hand, if the CCP is wound down, with haircuts applied to non-defaulting members' collateral, then current members at the point of default pay according to their exposure.

If the losses are not caused by member default related costs, but are the fault of the FMI, such as fraud or investment losses, then distribution should not affect the membership, but rather the FMI and its shareholders/bondholders.

Q12: Should an FMI's rules for addressing uncovered losses be taken into account when calculating whether creditors are no worse off in resolution than in liquidation?

Comment:

From our point of view, it is impossible to define ex-ante, or even ex-post, in what form of recovery or resolution what kind of creditors would be worse off than in liquidation. As no clear rules can be defined, the decision regarding the concrete recovery or resolution must be decided by the respectively responsible RA.

Q13: Are there any circumstances in which the ability to exercise termination rights as a result of the use of resolution powers should outweigh the objective of ensuring continuity?

Comment:

Yes, if service continuity is only thought to be feasible by either sale of the "good" FMI (or including "bad" parts, albeit with funds to compensate for these), or transfer to a bridge FMI, or a recapitalization, then the RA and other stakeholders may require time to enact these changes. During such measures, a freeze on the markets, and membership, may be extremely useful. However, extreme care should be taken that the failure of FMIs which are linked to each other, including non-credit risk taking FMIs, do not disrupt the healthy FMIs.

Q14: Are there any circumstances in which a temporary stay on exercising termination rights should apply for any event of default and not just where triggered by the resolution measures?

Comment:

CCPs must ensure that members seeking to leave the CCP do not substantially disrupt it, and as such must carefully address the responsibilities of leaving members. This does not necessarily need to be in terms of termination right stays, but can be a contractual arrangement in the rules and regulations of the CCP.

Q15: Are there any circumstances in which a moratorium with a suspension of payments to unsecured creditors may be appropriate when resolving an FMI? Should this be limited to certain types of FMI and/or certain types of payment?

Comment:

Depending on the concrete circumstances a moratorium with a suspension of payments can be an appropriate mechanism to be applied by the RA, providing all parties involved with enough time to decide on the most appropriate form of recovery or resolution. A temporary suspension of payments may enable the RA to observe whether market disruptions are short-term or caused by more severe disruptions. Depending on the FMI, a temporary closure of markets is common practice even outside of RRPs, e.g. in times of extreme volatility.

A moratorium can be appropriate for different kinds of FMI, whereby in any case a close monitoring of other (interlinked) FMIs is absolutely crucial.

Q16: If so, should resolution authorities retain the discretion to apply a moratorium and, if so, what restrictions (if any) on its use would be appropriate (e.g. scope, duration or purpose)?

Comment:

A moratorium should be applied mainly to buy the RA time to decide on the next steps and the most appropriate form of recovery or resolution. As such, it seems unfeasible for such moratorium to last for months. However, a concrete maximum duration is difficult to be defined.

In case of a CCP, the maximum scope for such moratorium would be the entire product spectrum cleared by such CCP. However, depending on the concrete set-up of such CCP and the markets it clears, it might be feasible to apply a moratorium for just some asset classes, whereas other asset classes are kept open. When applying a moratorium, it is crucial to consider interoperability agreements with one or more other CCP(s) as a suspension of payments might cause severe problems for such CCP(s), too.

Q17: Should the bail-in tool be available to collateral, margin (including initial margin) and other sources of funds if they would bear losses in insolvency?

Comment:
Ideally yes, since the exposure of the members reflects their interest in the CCP. However, the application of haircuts to non-defaulting member collateral must be carefully weighed in terms of the plans for the CCP: if entire asset classes are transferred to new CCPs, a substantial portion of the collateral should follow, so as to prevent double funding issues. On the other hand available collateral could be used, for instance, to cover any losses to the RA for emergency funding if the CCP is to be wound-down.

Q18: In what circumstances and for what types of FMI should wider loss recovery arrangements exist beyond the FMI's own rules and the resolution powers of the resolution authority?

Comment:
In case of the FMI being a CCP, it might be feasible for direct members of such CCP to implement loss sharing mechanisms with their clients. If for example, additional financial resources are required to re-establish the CCP such requirements could, in part, be passed on to indirect members of such clearing system.

Q19: In conducting a resolvability assessment of an FMI, what factors should authorities pay particular attention to?

Comment:
When deciding on the concrete form of recovery or resolution to be applied, the RA should consider the value of such FMI to the wider economy, as well as the markets served by such FMI. It seems very difficult if at all possible, to ex-ante define what concrete quantitative measures should be considered in such assessment.

C. Closing

We hope that you have found these comments useful and remain at your disposal for further discussion. If you have any questions please do not hesitate to contact:

Thomas Book
Member of Eurex
Clearing Executive Board
Eurex Clearing AG

Thomas.Book@eurexclearing.com

Oliver Haderup
Senior Vice President
Clearing Initiatives
Eurex Clearing AG

Oliver.Haderup@eurexclearing.com