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Dear sirs,

CPSS/IOSCO Consultative Report on Resolution of financial market infrastructures

This paper provides the response of the LCH.Clearnet Group ("LCH.Clearnet") to CPSS and IOSCO's consultation on "Recovery and resolution of financial market infrastructures".

LCH.Clearnet is the world's leading clearing house group, serving major international exchanges and platforms, as well as a range of OTC markets. It clears a broad range of asset classes including: cash equities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps and bonds and repos; and works closely with market participants and exchanges to identify and develop clearing services for new asset classes.

LCH.Clearnet appreciates the opportunity to respond to the consultation paper and supports CPSS-IOSCO's objective to enhance the mechanisms available for dealing with the recovery and resolution of financial market infrastructures.

Responses to specific questions raised in the consultation paper

1. **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?**

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

We agree that CCPs, which provide necessary services for the clearing of financial instruments, require specific processes to be established to ensure the continuity of critical services. In relation to the powers of the officials handling CCP recovery and resolution, we believe that resolution authorities should set specific objectives that must be achieved and have powers of direction over officials to ensure these are met. These should also include obligations to consider the impact of their actions on other FMIs to which the recovering/resolving FMI is connected, and to the stability of international markets.

A key consideration that must be borne in mind is whether there may be circumstances where authorities should have the ability to prevent a clearing member ("CM") from relinquishing their membership in a CCP under recovery or resolution.

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

4. **To what extent should the possibility of a tear-up in recovery be articulated in ex ante rules?**

5. **Should there be a limit to the number of contracts that are eligible for tear-up?**

6. **How should the appropriate haircuts be determined?**

Recovery and resolution of CCPs may be more easily achieved if each service – i.e. where the CCP has established a separate default waterfall in respect of specified business lines – is considered separately. This should enable means that one service of the CCP, e.g. one that is less systemically important, must be able to fail whilst other services continue to operate.

The logical conclusion of this is that each service of the CCP should be "limited recourse", meaning that once it has failed the liabilities of that service should not be obligations of any other service. This limited recourse provision would state, for example, that once the default waterfall is exhausted, contracts are torn up. In 3.13 there is a clear assumption that tear-up can meet the shortfall on the defaulter's book with certainty. This is only definitely true if the haircutting process starts as soon as or before the available non-defaulters' and CCP resources allocated to the service in question have been exhausted, and indeed only then if either all risk premium in hedging and auctioning has already been incurred or can be obtained within any excess resources. Note that full tear-up would in effect constitute a cessation of service and may belong in resolution rather than recovery.

The impact on clients of the tear-up of client positions should also be considered. There is essentially a political decision to be made over the exposure of clients versus the exposure of clearing members on their proprietary positions (as with variation margin ("VM") haircutting, as noted below).

We suggest that losses should not be imposed on CCPs with which the failing CCP

operates an interoperable link or similar arrangement, to avoid further contagion.

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

8. **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 (eg losses in investments made by the FMI)? In what circumstances, and by what methods, should losses be passed on beyond the direct participants – eg to the clients or FMI shareholders – in resolution?**

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

The CCP regime should be triggered by a regulatory determination of "non-viability" (rather than formal insolvency; as the Report states, this is to be avoided in the case of FMIs and a resolution process entered instead). This could involve an assessment of performance or likely performance against relevant regulatory requirements. It is important (a) to be clear that this trigger is different from and is capable of preceding the balance sheet type tests usually relied upon in insolvency law; and (b) to clearly set out the point at which the resolution authority becomes responsible for resolution and the exercise of any discretionary powers (as opposed to the Directors of the CCP).

The resolution authority needs the same range of tools as a bank resolution regime; in particular the ability to take part of the undertaking of a CCP and transfer it either to a bridge entity or to a private sector purchaser (this links in with the idea of compartmentalising the CCP's operations in a limited recourse structure as noted above).

Starting from the assumption that a loss has been incurred which exceeds the capital of the CCP then the question is who should bear the loss and in what proportions. As the aim of a resolution regime is to avoid taxpayers bearing the loss then there are broadly two options: (a) creditors of the business generally, or (b) certain specific pre-designated creditors. As the Report's authors are aware, the application of general insolvency law principles is likely to lead to a solution akin to (a). Resolution regimes generally try to modify this effect in favour of (b).

There are potentially four phases in this scenario, and as far as possible the boundaries between these should be clearly established:

- First, a recovery process that is defined in a CCP's rules and effected by the CCP's management. This includes conventional default management (which goes to the depletion of the defaulter's resources and the default waterfall, and loss allocation

processes such as variation margin haircutting and, ultimately, tear-ups); there could be the possibility of including a voluntary recapitalisation process in this stage;

- There may come a point at which the CCP's supervisor takes a decision to take control of the recovery process, allocate further losses and use additional tools, including recapitalisation, in order to ensure continuity of some or all of the CCP's services;
- If this also proves insufficient, resolution is accomplished e.g. by business sales/transfers, There could then follow a third phase which is recapitalisation of the CCP;
- Finally, and to be avoided, there must remain formal insolvency of the CCP.

Loss allocation must be used only in cases where the default waterfall – including recourse to the CCP's dedicated own resources – has been exhausted and the CCP is faced with potential insolvency. It is almost certainly true that systemic uncertainty will be minimised if the process to be followed on the failure of a CCP, both as regards rebalancing the CCP's book and as regards recapitalisation resolution, is prescriptive and public. The more discretion is available, either to the CCP management or to regulators, the greater the level of systemic risk that the possibility of a failure will create.

Current practice indicates that the optimal design for a loss allocation system is probably based on VM haircutting. The main theoretical alternative is initial margin ("IM") haircutting. However, under EMIR IM haircutting is clearly not available to European CCPs and even where it could be possible we believe that it would materially reduce the incentives to clear OTC derivatives (where firms will still have the choice) as it undermines the basic purpose of CCP clearing, i.e. reducing counterparty credit risk.

<u>VM Haircutting</u>

One of the biggest issues as regards VM (and, to some extent, IM) haircutting is whether client balances should also be required to suffer these haircuts. That is essentially a policy decision. The other significant issue is whether there should be a cap on the exposures of CMs. These exposures will be capped by the economic terms of the contracts to which they are party. However the imposition of caps raises the question of where excess losses would fall. In either case the impact on regulated entities' capital requirements will have to be examined.

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

11. 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 (eg losses in investments made by the FMI or resulting from operational risks)?

12. 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?

As stated above, CCPs are more easily resolved if their services are considered separately. It is important to both the public sector and CMs that it be possible for one service of the CCP to fail whilst other services continue. This ought to mean that only part of the CCP's capital should be used in the failure of any particular service, since once the whole of the CCPs capital is exhausted, the CCP as a whole will have failed. This will apply under the EMIR regulation to EU CCPs under the requirement to allocate a portion of dedicated own resources within the default waterfall before using non-defaulters' default fund contributions, and could also apply to further post-waterfall capital depletion.

Non-defaulter losses

CCPs can theoretically fail for one of two reasons: (a) losses stemming from a CM default and (b) credit loss (or fraud) in the CCP for reasons unconnected with its cleared business. The big question in relation to (b) is whether clearing member resources should be available in a resolution triggered by these causes. From the point of view of service continuity it makes sense to access clearing member resources. However, it is likely that clearing members would demand a large contribution of CCP capital and that this should be at the top of the waterfall. In relation to losses on the CCP's treasury book, bail-in of treasury counterparties is another theoretical alternative although this is unlikely to be universally popular.

13. **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?**

14. **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?**

Yes. A limited moratorium on exercising close out rights should not be too disruptive and would appear to be an essential component of any effective resolution mechanism. Outside of resolution, the answer is also yes (LCH.Clearnet Ltd already requires a 30 day grace period in respect of its obligations).

15. **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?**

16. **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 (eg scope, duration or purpose)?

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In order to reduce the systemic consequences of fear of CCP failure it is important that the scope of a potential moratorium is clear in advance and have a limited discretionary element.

17. 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?

In principle yes, but see above our comments on IM haircutting. Similar issues arise relating to bail-in.

18. 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?

We have not identified any such need.

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

As noted above, the ability of surviving business lines to continue to operate following the failure of one business line is a key factor.

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We hope that CPSS and IOSCO find this contribution useful and we look forward to engaging further as policy options are developed. We also urge you both to use all your power and influence to encourage individual jurisdictions to take a common approach to implementing any final proposals. We recognise that separate jurisdictions will necessarily be starting from different positions and will not be able to move together at the same speed. Nevertheless in this issue of fundamental importance to systemic stability a harmonised global approach is vital.

Yours faithfully

Ian Axe
Chief Executive Officer