

The Hon. Randal K. Quarles
Chairman, Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2, 4501
Basel, Switzerland

SUBMITTED VIA EMAIL

July 31, 2020

Re: CCP RESOLUTION

Dear Chairman Quarles:

On 4 May 2020 the Financial Stability Board issued draft guidance on the resolution of central-counterparty clearing houses, seeking comments by 31 July. The Systemic Risk Council considers that the proposed guidance is not fit for purpose as it currently stands, since it does not provide a clear, internationally agreed solution to the problems of pro-cyclicality and the currently inadequate incentives embedded in plans based on clearing houses' existing rules. As such, the draft guidance does not solve the de facto stand-off between resolution authorities and supervisory agencies responsible for recovery plans. In consequence, they do not adequately mitigate the increased systemic significance of central counterparties (CCP) resulting from the post-2008 crisis requirements that more capital-markets activity be centrally cleared.

The Systemic Risk Council (SRC) is concerned that, as things stand, the guidance would leave the world relying on recovery mechanisms that could, in some circumstances, seriously exacerbate or even trigger a financial crisis. The SRC urges the Financial Stability Board (FSB) to continue working, as a real priority, to produce an agreement for its members to put in place credible resolution regimes and plans for clearing houses, including articulating a standard that would effectively determine whether clearing houses' rules need to be amended in order to promote orderly resolution.

Background

The latest FSB paper is very similar in substance to one it issued on 15 November, 2018. It remains largely a checklist of things to think about. The main changes are increased detail on the recommended process for assessing the adequacy of the financial resources of clearing-house central counterparties (CCPs) and the tools available to authorities to support the resolution of a CCP, together with a broader discussion of the issues that authorities should consider in addressing how CCP owners' equity is treated in resolution. The SRC considers that those two additions do not satisfactorily address the outstanding issues, and so should not bring closure to this debate.

The SRC responded to the FSB's earlier consultation in a letter of 18 March 2019, arguing

that serious issues needed to be addressed.¹ Since we set out our concerns in some detail then, this letter merely summarizes the main points, which remain valid.

Relying on recovery plans risks pro-cyclicality

The community of clearing-house managers and at least some of their statutory regulators continue to believe that the recovery plans embedded in CCPs' rule books will suffice in any foreseeable circumstances. We disagree that it is safe to rely upon this.

As with any other debtor, if a CCP exhausts its primary loss-absorbing capacity, the excess losses have to go somewhere if a bankruptcy proceeding is to be avoided. For CCPs, that primary loss-absorbing capacity is initial margin moneys (in the case of a member default), the default fund, and the owners' equity. After that, depending on the CCP's rules, members might be obliged to replenish the default fund (perhaps more than once, but a finite number of times). After that, a CCP has to renege on some of its obligations in order to extinguish its losses. For example, it might tear up contracts, or haircut variation-margin obligations, or haircut initial-margin obligations (if they do not have watertight legal protection).

The SRC is not saying that there are no conceivable circumstances in which those steps could work without exacerbating the market crisis affecting the clearing house. But it would be imprudent for any CCP to rely on that, and it would be a mistake for the authorities to do so given the social costs of financial instability and their responsibilities for maintaining stability. This is because as members and users became aware of a clearing house's pending distress, they would have strong incentives to close out contracts and sell related assets, in order to reduce or eliminate their credit exposures to the CCP. The unintended effect would be to drive down asset prices, and stretch liquidity in already stressed markets, raising the probability of further losses to other market participants and to the clearing house itself. If and when that happened, the authorities would be faced with a choice of allowing the downward spiral to develop or stepping in to ensure the clearing house was made whole, removing the need for members to flee.

The core objective of G20 financial stability policy is to ensure that distressed intermediaries and infrastructure-service providers can be resolved without tax payer solvency support and without exacerbating financial instability. The SRC remains concerned that not enough has been done to address that objective in the case of CCPs.

Two guiding principles

As this debate has dragged on --- for over half a decade --- SRC members have become concerned that clearing-house owners and managers might not be properly incentivized to internalize the possible systemic consequences of their distress or failure. It seems possible that rather than thinking of themselves as risk managers of super-systemic infrastructure, which is unquestionably what CCPs are, they see themselves as providing operational and information-technology services to their members.

With that in mind, the SRC's earlier letter proposed two principles to guide the policy of the FSB and its members, which we now repeat:

¹ Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (Mar. 18, 2019), available at https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2019/03/New-CCP_Resolution_-_SRC_-_March18__2019.pdf.

- 1) In order to incentivize owners to act as systemic risk monitors and managers, owners' equity should be eliminated upon a CCP's entry into resolution (or bankruptcy) or they should not keep the CCP's profits
- 2) In order to mitigate pro-cyclicality, resolution regimes and plans should distinguish between "operational" and "pure financial" liabilities, with changes made if necessary to clearing houses' rules

Owners' equity should be at risk if CCPs are for-profit institutions

It is unreasonable to expect clearing houses to focus on systemic risks if owners keep profits during the good times but, rather than being extinguished, survive the worst times with their rights to surplus income intact; that, of course, amounts to a subsidy from members and users, and in some circumstances potentially from taxpayers. Their incentives matter hugely to preserving stability in the system, given they set the margin and other requirements that shape the availability and use of leverage in trading markets.²

The first principle is designed, therefore, to ensure that a clearing house's ownership and management is a regular part of a market economy. If owners object to putting their equity at risk, then they should not own for-profit entities which take huge notional counterparty-credit exposures and other financial risks. Instead, they could have a contractual relationship where they receive a fee for providing operational services rather than, as now, the excess cash flows and profits of the clearing houses they run. The authorities need to look again at the level of tangible equity required for each CCP managed by a clearing-house operator, and the exposure of the owners' equity in the loss-waterfall.³

Distinguishing between operational and pure financial liabilities to mitigate pro-cyclicality

The second principle, explained more fully in our March 2019 letter, is designed to help overcome the pro-cyclicality hazard. The important thing is that once the primary loss-absorbing capacity is exhausted, excess losses should fall on obligations of the distressed clearing house that cannot be avoided by members terminating business or closing-out contracts. Margin obligations are operational obligations, as they are inherently part of providing a service, and so can be altered by members' changing their use of the service.

We aired the possibility of members having to subscribe to a bailinable bond in a quantum equal to a slow-moving average of each member's use of the CCP (whether measured by open interest, initial margin, or default fund contributions). These would be purely financial liabilities, albeit ones whose value would be related (with a lag) to members' use of the clearing house's services as a central counterparty.

Bringing the two principles together

Bringing the two principles together, we also aired the possibility of such bonds being converted into equity in certain circumstances, which would recapitalize a failing clearing

² Addressing the hazard of margin requirements being affected by races to the bottom among competing clearing houses goes beyond resolution policy, but a credible resolution policy regime and plans could affect the incentives of clearing-house risk managers, their bosses, and owners.

³ Some clearing houses operate more than one CCP, with different central counterparties for different centrally cleared markets.

house. In summary, in the event of a CCP going into resolution, the bonds would be written down sufficiently to cover the excess losses, and partly converted into equity to restore the equity of the afflicted CCP(s) after the owners' equity was written off.

That being so, the existing owners could be given a right of first refusal to invest in such bailin bonds, with clearing members being obliged to do so if the owner did not exercise their rights to invest. In the latter circumstances, if ever the bailin bonds were converted, ownership of the CCP would shift to the community of clearing members. Once allotted, such bonds would be non-transferable.

To make something like this work, the rules of many clearing houses would probably need to change.⁴ That is partly because the No-Creditor-Worse-Off-than-in-Bankruptcy principle, enshrined in law in some jurisdictions, means that a resolution authority could not easily depart from the approach that, given a clearing house's contractual rules, a bankruptcy administrator would apply.

In contrast to banking institutions, clearing houses are largely algorithmic, but that means the algorithms embedded in clearing houses' rules need to avoid pro-cyclical behavior and systemic spillovers during recovery and resolution. Certainly, resolution authorities need to be completely satisfied that existing rule books would not so impede resolution that a taxpayer bailout became inevitable if recovery measures were either not working or proving counterproductive for the stability of the system as a whole.

Summary

After the 2008/09 crisis, the G20 committed to ensure that every potentially systemic financial intermediary could be resolved in an orderly way, without taxpayer solvency support, and aiming to contain the costs of financial instability. This has not yet been achieved for central-counterparty clearing houses, which are super-systemic elements of the international financial system. A tragic lesson of 2008 is that what can be foreseen can happen, and what can happen sometimes does happen. An unresolvable distressed clearing house, transmitting disorder as it seeks to restore itself, is a foreseeable disaster. Policymakers should address this continuing fault-line in the international system.

⁴ The SRC is not aware of any significant amendment to loss-allocation waterfalls in a CCP's rules to cater for resolution in the event of large losses from member defaults or other causes. If that is correct, it implies either that everything was fine before the FSB focussed on CCPs or, alternatively, that little progress has been made.

Yours sincerely,



Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council

www.systemicriskcouncil.org

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Sir Jon Cunliffe, Chair, Committee on Payments and Market Infrastructures
Ashley Alder, Chair, IOSCO

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