

Mr Klaus Löber  
Chair, CCP Supervisory Committee  
ESMA  
103 rue de Grenelle  
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France

20 September 2021

Dear Mr Löber

International standard setters and global authorities have made important progress in advancing the regime for CCP Recovery and Resolution (R&R) in the era following the Pittsburgh G20 meeting. We recognise the passage of primary legislation on CCP R&R in the EU and welcome the opportunity to [comment on its implementation](#). As the global association representing CCPs,<sup>1</sup> we take a keen interest in the EU regulatory framework, not only because of the importance of EU derivatives markets and CCPs globally, but also to the extent that the EU is a regulatory thought-leader whose actions are closely observed by authorities across the globe.

Individual EU CCPs within our membership will respond to many of the detailed questions ESMA has posed in the series of consultations on RTSs and Guidelines related to CCP R&R. We at the WFE wish to engage in the process by reiterating in this letter the strategic principles we regard to be relevant to these consultations and indeed the legal/regulatory framework and global standards concerning the recovery and resolution of CCPs. In doing so, we wish to focus on three areas: incentives; non-default losses; and the role of the resolution authority. We believe that ESMA has the opportunity to implement EU CCP recovery mandates in a way that supports the stability of the financial system and the coherence of global approaches under the CPMI-IOSCO *Principles for Financial Market Infrastructures*.<sup>2</sup>

#### *Incentives*

A core element of central clearing's value is the predictability of the arrangements to address pre-specified contingencies, which reinforces the incentive structure established by the central clearing model. This value has been enhanced by the extensive policy strides the international community has made to build on CCPs' reliability through the 2008 crisis and to ensure coherence and consistency in the policy applied to financial systems worldwide, particularly through the CPMI-IOSCO *Principles for Financial Market Infrastructures*.

The relationships between clearing member, client, and CCP are finely balanced through a carefully constructed incentive structure, and any policies having the unintended effect of upsetting this balance ought to be avoided so far as possible.

Acknowledging that the EU legislation on CCP R&R will establish a second tranche of skin-in-the-game (SITG) for EU CCPs, we wish to echo the view of the Financial Stability Board:

"SITG is not calibrated with a view to constituting a significant amount of loss absorbing resource. Rather, SITG is calibrated to provide confidence in the risk-management incentives of the CCP."<sup>3</sup>

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<sup>1</sup> The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 250 market infrastructures, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%). with everything from local entities in emerging markets to groups based in major financial centres. Collectively, member exchanges are home to nearly 53,000 listed companies, and the market capitalisation of these entities is over \$95 trillion, while the 50 distinct CCP clearing services (both vertically integrated and standalone) collectively ensure that traders put up \$1 trillion of resources to back their risk positions.

<sup>2</sup> CPMI-IOSCO, [Principles for financial market infrastructures](#), April 2012.

<sup>3</sup> FSB, [Financial resources to support CCP resolution and the treatment of CCP equity in resolution](#), November 2018.

Market participants, of which there are many compared to CCPs, have clear incentives to increase the amount of equity a CCP places into the waterfall. Not only would they benefit from a reduction in the capital they hold towards their exposures to the CCP, but they would also benefit from the safety accruing to them with increased loss absorbing resources available from others. This increase in the level of protection is, however, not costless for clearing offerings and for the system. In the long-run, one could see investment in CCPs decrease, or indeed the cost of clearing increase. Notwithstanding these important concerns, perhaps the most challenging element of increasing CCPs' capital contribution to the default waterfall is the risk of upsetting the fine balance of incentives that currently prevail in the cleared universe.

CCPs are risk management entities, serving to *manage* the risks brought by market participants, not to *underwrite* the risk that market participants bring—the latter being a role more akin to that played by an insurer. CCPs through multiple disclosures, external validations and indeed a level of capital at risk demonstrate to the market how risk is managed. Ongoing work by international standard setters is aimed at further refining these disclosures and we would submit that the most pressing and useful further refinement of disclosure standards would be those by clearing members and clients. To be clear, this would be of benefit to the system, as well as to CCPs. As for the discussion on the sizing of the second SITG tranche, very careful consideration needs to be made as to the construction of any additional capital so that it does not blur the lines between the CCP as a risk manager and CCP as 'insurer.'

The resolution of a CCP would be a highly disruptive extreme tail event; the recovery of a CCP is a far preferable outcome for all concerned. The risk management practices and recovery plans that CCPs have adopted in the post-crisis era have been carefully designed in close co-ordination with a CCP's local regulatory authorities in consideration of applicable international standards. Any plan developed by resolution authorities should be mindful of the potential impacts on a CCP's risk management and recovery tools and be designed to ensure that it does not reduce the likelihood of successful CCP led recovery and should focus on prioritizing the stability of the broader financial system. Such considerations will be particularly important as ESMA focuses on topics including triggers for early intervention in CCP resolution, indicators for going from BAU to recovery, and recovery scenarios.

The implementation of a resolution plan should be a joint effort between the CCP and its home regulator, with appropriate communication with other global regulators through the CCP's Crisis Management Group. A regime providing incentives for market participants to see the CCP resolved rather than recover would be antithetical to supporting the stability of the broader financial system and inconsistent with the *Principles for Financial Market Infrastructures*.

Following on from this, mechanisms for compensating market participants in a CCP resolution scenario outside of those established under no creditor worse off (NCWO) framework risks perverting the incentives that exist to support the default management process and recovery of that CCP.

#### *Non-default losses*

CCPs are, and have been historically, highly secure market infrastructures that prioritise service continuity and operational risk management. In the case of an NDL occurring, CCPs allocate the losses in ways that preserve the incentive structure of central clearing for market participants to appropriately manage their risks. A CCP's rulebook and recovery plan governs the allocation of different types of NDLs. This allocation should depend on the type of risk causing the loss and more granularly, the facts and circumstances surrounding a given NDL. A CCP may not be (or solely be) responsible for all types of NDLs; these may include losses deriving from activities where other stakeholders benefit from (or control) the antecedent rewards and risks (as negotiated and agreed in the CCP's rulebook). As ESMA goes about identifying scenarios for recovery as part of this consultation, these nuances will be important to bear in mind.

NDLs resulting from the general business operations within a CCP's control are normally borne by the CCP. Furthermore, third-party custodial and banking losses are an example of a loss type where, throughout the financial system, liability is disclaimed; the same is appropriate where a CCP holds collateral on behalf of its

clearing members and their clients. Investment losses may also be disclaimed in certain scenarios and to varying extents dependent on CCP's risk management practices and the regulatory framework under which the CCP operates.

#### *Intervention of the Resolution Authority*

The circumstances that might give rise to the enactment of a CCP recovery plan are extreme. It is important that the CCP be able to discharge the policies set out in its rulebook in such a stressed scenario. Likewise, it is important that it retains sufficient flexibility to discharge its recovery plan in a manner that takes account of the particularities of the situation, the specificities of its own corporate/legal structure and that ultimately supports the stability of the broader financial system.

We believe the interests of the financial system are best served by a regime that is designed primarily to avoid resolution and instead, incentivize market participants' active participation in the recovery process. In the extreme and remote scenario of a potential CCP resolution, the resolution authority should intervene after the exhaustion of the resources and tools defined for recovery in a CCP's rulebook and recovery plan. If a resolution authority were to intervene prior to this, the incentives market participants have to actively participate in the recovery process are undermined; ESMA ought to be conscious of avoiding such a scenario as it goes about drafting guidelines on early intervention. It is important that triggers for early intervention be circumscribed to scenarios justified based on financial stability objectives.

In such a scenario, a CCP could face unnecessary and unexpected complications in working through a period of stress for itself and the system. In particular, the current treatment of CCP equity has been carefully determined, consistent with international standards, to promote incentives for market participants to back the risks they bring to the CCP, as well as to support the stability of the broader financial system. An essential part of this consists of incentivising market participants' effective participation in the default management and recovery processes.

While we understand the intention of EU CCP recovery and resolution legislation to complement EMIR in general, as ESMA notes many requirements construed as early intervention measures are powers already vested in supervisors. A clear distinction between supervisors' day-to-day duties, and those called for early intervention measures, would help to ensure predictability and clarity on the operation of recovery and resolution processes.

It would run contrary to the regulatory framework's predictability and clarity to introduce early intervention assessment triggers which are analogous to indicators addressed in recovery plans. For example, a significant clearing member default could result in temporary breaches in a CCP's capital requirements; under EMIR the CCP is obliged to accordingly replenish its capital within six months. This type of breach for which the CCP has proposed a plan of action ought not be perceived as an indication that an early intervention assessment would be required.

#### *Conclusion*

We are grateful for the opportunity to comment on this important series of consultations and reiterate our global perspective on these themes related to CCP recovery and resolution. Should you wish to discuss these matters further with us and our members, we remain at your disposal.

Best regards



Nandini Sukumar

Chief Executive Officer

