

# Chicago Fed Letter

## 2015 Conference on Central Counterparty Risk Management: Resolution

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The Federal Reserve Bank of Chicago hosted its second annual Conference on Central Counterparty Risk Management on November 3, 2015. Panelists from regulatory authorities, central counterparties (CCPs), CCP service providers, financial institutions, and resolution authorities discussed initiating CCP resolution proceedings, managing a CCP in resolution, and consultation and coordination during CCP resolution proceedings.

As an aid to free discussion, the meeting was held under the Chatham rule (<https://www.chathamhouse.org/about/chatham-house-rule>). Except for the keynote speaker, participants' names are withheld.

**For** the purposes of the conference, *resolution* was taken to mean the point at which a public authority (a “resolution authority”) steps into the place of the CCP and takes over the responsibility for exercising the CCP’s recovery tools and other actions as granted by law. The resolution authority may be a court, central bank, or other governmental agency such as the U.S. Federal Deposit Insurance Corporation (FDIC). The resolution authority may *wind down* or discontinue the operations of the failing CCP if the CCP is determined to no longer be viable; alternatively, the resolution authority may take steps to restore the CCP to orderly operation, a process that might be considered *rehabilitation*.

In this *Chicago Fed Letter*, we provide a summary of the keynote address by Kay Swinburne, Conservative MEP (member of the European Parliament) for Wales, and the conference panel discussions.

### Keynote address<sup>1</sup>

#### Key points

- Resolution is inherently a political process—a public authority takes over a failing CCP and is responsible for managing it in an orderly fashion, with important consequences for the broader economy.

- As a result of the clearing mandate, end users of cleared markets are, in effect, forced to clear their trades. This necessitates both prudential regulation of CCPs and sensitivity to end-user interests if a CCP enters resolution.
- Politics involves recognizing a variety of interested parties, some of whom may not be involved in the governance of the CCP. This is both essential and problematic as CCP resolution requires expedient and effective action.
- The impact of resolution is likely to be severe, which means that CCP regulation must be well designed and implemented and considerable effort made to avoid resolution.

Swinburne emphasized the importance of the political aspects of CCP resolution. Within the European Union (EU), for example, it was a political report that drove the discussion of CCP resolution in the European Commission, and the European Parliament will be involved in any proposals suggested by the European Commission.

Swinburne placed the discussion of CCP resolution in the larger context of developments in the central clearing space since the financial crisis. She noted that regulatory changes in capital

requirements, mandatory clearing of swaps, and the liquidity coverage ratio have fundamentally altered the CCP-clearing member relationship. In particular, capital requirements encourage market participants to clear more than ever, giving CCPs an incentive to create more products. The mandatory clearing requirement raises questions about what resolution tools are politically viable and makes it imperative that CCPs be subject to robust supervision. Swinburne suggested the political dividing line for when resolution begins is the point at which the tools used would affect those without a say in the governance of the CCP.

The point of non-viability for a CCP, according to Swinburne, is when clearing members no longer voluntarily and predictably participate in an auction. At this point, restoring a matched book at the CCP must be the primary concern. However, she questioned whether a commercial entity should have control of the tool box at this point, given the potential for a conflict of interest since the CCP has an obligation to both shareholders and clearing members. Although forced allocation of contracts and partial or full tear up would be the most expedient means of returning the matched book, Swinburne noted that this would be a politically unacceptable action by a for-profit entity. Instead, only a resolution authority should be able to choose which contracts are eligible for tear up. However, this action poses significant difficulties for the resolution authority, since it does not have insight into the purposes of each individual contract.

Swinburne also addressed timing considerations—in particular the trade-off between the resolution authority stepping in too early, which may spook markets, and too late, when there are no viable resolution tools left in the tool box. In either case, she said, the biggest moral hazard concern is the risk of putting in place measures ahead of time that may hasten the arrival of non-viability.

Finally, Swinburne emphasized that the greatest political challenges are deciding who should sit on crisis management groups, what their powers should be, and who should get the final word in making resolution decisions. In the event

of a CCP resolution initiation, there will be a multitude of affected parties. In making decisions about what actions to take, someone must have the last word. However, deciding who that should be is a complicated task in international coordination and cooperation. Additionally, there may be legal barriers that prevent clearing members in one jurisdiction from participating in resolution measures taken in another jurisdiction. Regardless of what decisions are ultimately made and how they are agreed upon, Swinburne highlighted the need to ensure a level of predictability in resolution proceedings, as well as legal certainty in regard to the resolution process.

### Session 1

*Panelists representing:* public authorities, CCPs, and the financial services industry

In the first session, panelists discussed the legal, regulatory, and policy issues surrounding the initiation of CCP resolution proceedings. They discussed the applicable laws and policies in various jurisdictions, requirements for initiating resolution, consultation and coordination among regulators, and the regulatory approvals necessary for the CCP to continue operations.

### Key points

- While many jurisdictions have established some legal and regulatory guidance for the resolution of a CCP, the measures were largely modeled after bank resolution and remain untested.
- CCP resolution will likely need to take place more quickly than bank resolution. For this to occur smoothly, appropriate prudential regulation must be established ahead of time.
- Definitional differences of default and failure could lead to a discrepancy across jurisdictions in initiating resolution proceedings.

In the UK, a resolution regime for CCPs was set up in 2014 as an adaptation of the bank resolution regime set up in 2009. This resolution regime aims for continuity of clearing services by providing a tool for the transfer of service. However, according to one panelist, the existing resolution tools do not include many that were outlined in the Financial Stability

Board's (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions, namely, contract tear up and write down of margin.

In Singapore, the current CCP resolution planning has also borrowed from the banking regime; however, a more CCP-specific regime is being developed that would include specific triggers for resolution.

CCP resolution legislation is being prepared in Australia.

In Europe, the legislation under development would include the full set of tools outlined in the FSB Key Attributes; it is likely to be proposed some time next year.

In the U.S., Title II of the Dodd-Frank Act (DFA) provides an alternative mechanism for CCP resolution via an orderly liquidation authority. Under the DFA, the goals of the resolution process are: to develop resolution plans ahead of time (under Title I or otherwise); authorize the FDIC to serve as a resolution authority for certain systemically important financial companies and allow the FDIC broad powers, including the authority to create a bridge institution to continue operations; provide potential access to funding; and transfer qualified financial contracts to another third party (likely the bridge institution).

Next, panelists addressed timing concerns once resolution is triggered. One panelist noted that, unlike in bank resolution, the resolution of a CCP will likely need to be done in a much shorter time than over the course of a weekend, given the multiple rounds of variation settlement that occur each day. A CCP representative suggested the possibility of instituting a temporary market shutdown in the event that resolution proceedings needed to begin prior to the weekend. Another CCP representative echoed the concern that a CCP could run out of time in the middle of the day, in which case there might not be enough time for a resolution authority to step in. These concerns led participants to conclude that prudential resolution proceedings must be established ahead of time and be well-understood by market participants.

In addition to the speed with which resolution is likely to begin, panelists discussed the different triggers for resolution across

jurisdictions. The Financial Stability Board has identified three broad considerations and four potential triggers of CCP resolution. Specifically, according to the FSB, resolution should be considered when the entity is failing or likely to fail, there is no viable alternative, or when it is in the public interest. Based on these considerations, the FSB has enumerated four likely triggers: all recovery measures have been exhausted, the CCP cannot be returned to viability, the CCP cannot comply with regulatory requirements, or the resolution authority determines that recovery measures are unlikely to work or may compromise financial stability. One panelist noted that these provisions allow for forward-looking judgment as well as some flexibility and discretion in beginning resolution proceedings. Other panelists pointed to the trade-off between a desire for flexibility on the part of regulators and the desire for certainty on the part of market participants.

The DFA provides for orderly liquidation under Title II if a systemically important financial company is in default or likely to default. This language is similar to, but different from, the language in the FSB's Key Attributes and EU legislation. Under the DFA, there are four ways for a financial company to default: capital insolvency, liquidity crisis, bankruptcy, and incurred losses that will deplete all or substantially all of its working capital. Panelists noted that the statute provides some flexibility and forward-looking discretion, allowing the resolution authority to begin resolution proceedings when the CCP is in default or near default. However, panelists also noted that the DFA's definition of default is not the same as the FSB's definition of failure. A panelist pointed out that these differences could lead some authorities to trigger resolution ahead of others.

Finally, panelists addressed the notion of legal certainty regarding actions taken by a resolution authority. One panelist noted that with the existing set of triggers and resolution tools, there is significant room for discretion. However, panelists agreed that once resolution has begun, it is unlikely that any action taken would be reversible or come under judicial review.

## Session 2

*Panelists representing:* public authorities, CCP service providers, and CCPs.

In the second session, panelists addressed four aspects of managing a CCP that has been put into resolution: establishing and communicating the objectives of the resolution process, key risk management actions, critical operational actions, and establishing financing arrangements.

### Key points

- With a CCP in resolution, the primary objectives are continuity of service and establishing a matched book.
- Any actions taken by the resolution authority relating to the above objectives should ensure that losses fall on private resources and market stability is maintained.
- At the point when a resolution authority takes over, key operational personnel must be involved. These individuals should be identified ahead of time and “fire drills” with the potential resolution authority might be undertaken to ensure a smooth transition in the event of catastrophe.

A representative of a CCP service provider outlined the importance of the transition of control of a CCP to a resolution authority. Specifically, service providers would want to know which resolution authority is taking over, what the objectives are, and how the authority plans to achieve those objectives.

The FSB Key Attributes identify continuity of critical functions without taxpayer loss as a goal of CCP resolution. One panelist underscored the importance of financial stability concerns and establishing a matched book as drivers of resolution tools. Other panelists echoed the importance of establishing a matched book as a key first step; however, to do so, one panelist highlighted the need for the right incentive structures to be present.

A CCP representative expanded on the public interest aspect of CCP resolution, noting that CCPs serve a public utility function and, therefore, participants would like some certainty that obligations will be met. Panelists agreed that regardless of specific details, a key goal for any resolution authority should be to ensure

that private resources absorb any losses related to the resolution of a CCP.

With general agreement on the primary goals, panelists addressed the operational aspects of a resolution authority assuming control of a CCP. Panelists agreed that for the transition to go smoothly, key operational staff must be identified ahead of time. CCP representatives noted that these operational concerns are not new for CCPs and have been part of their business continuity planning. Although panelists agreed that identifying critical individuals has largely been done, they also noted that there is still a need to ensure that established plans are followed effectively in a moment of crisis.

Once a CCP is in resolution and key operational staff members are identified, risk management actions become the primary consideration of the resolution authority. One panelist noted that risk management tools begin well before the initiation of resolution. Once resolution begins, the risk management tools most discussed are margin haircuts, either variation margin or initial margin. Market participants have different preferred risk management tools. These competing viewpoints were reflected in the discussions among panelists, who

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addressed the potential for an initial margin haircut to cause a run, as well as the imbalance in distributing losses in the case of a variation margin haircut. Given the contentious nature of the issue, a panelist noted that the exact tools undertaken will depend on the situation. Given the lack of generalizability, panelists agreed that doing drills of potential situations would help prepare both regulators and CCP operators for handling these issues as they arise in real time.

In addition to taking operational and risk management actions, a resolution authority would also be required to seek appropriate financing arrangements to ensure continued operations of the CCP. One panelist underscored the importance of first establishing a matched book before any new capital could be brought in. Another panelist noted that pursuing claims against a defaulted clearing member is not a viable financing tool for a CCP in resolution. Participants agreed that public money should be ruled out as a financing option in resolution.

### Session 3

*Panelists representing:* public authorities and the financial services industry.

During the final panel of the day, participants addressed an array of domestic and cross-border consultation and communication issues. Panelists spoke about the challenges of coordinating among multiple domestic authorities with separate responsibilities, coordination with international authorities, and recognition and enforcement of cross-border resolution actions.

### Key points

- Effective coordination between domestic entities with different responsibilities necessitates a formal means of communication and joint decision-making to be established prior to the onset of a crisis.
- The failures of Lehman Brothers in 2008 and MF Global in 2011 highlight the need for fire drills and ongoing communication between domestic entities, as well as international regulators.
- Crisis management groups are widely recognized as an important way to

foster cross-border communication and ensure that resolution authorities in different jurisdictions have effective means of communication with their counterparts.

- There is significant room for additional guidance in the realm of cross-border recognition and enforcement of resolution actions.

Panelists described the challenges of consultation and coordination among domestic authorities in various jurisdictions.

In Japan, the Japanese Finance Committee is responsible for licensing, advising, and regulating CCPs. However, in the event of a material potential risk, the Financial Services Agency would work in consultation with the prime minister to convene the necessary people to determine if a resolution mechanism should be started. This would likely involve the Deposit Insurance Corporation of Japan, the Bank of Japan, and the Ministry of Finance. Coordination among all of these entities would certainly pose some challenges and would likely require establishing confidentiality agreements in advance. In addition, it would be important to establish a primary point of contact ahead of time.

Canadian rules related to CCP resolution are harmonized across the existing provincial regulatory system. In addition, plans for coordination among domestic entities will be outlined in new rules. However, for CCPs licensed outside of Canada, Canadian regulators defer to the CCP's home regulator.

In the United States, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have oversight responsibilities for CCPs, while the FDIC is the resolution authority. This poses challenges for intra-border communication; however, the FDIC does have a memorandum of understanding with the CFTC and SEC.

Next, panelists discussed the failure of Lehman in 2008 and that of MF Global in 2011 as case studies illustrating how important cross-border consultation and communication become in a crisis. One panelist noted that there was greater international cooperation in the case of MF Global, largely because people

realized the importance of this type of communication after the Lehman crisis. Panelists agreed that fire drills that test cross-border communication and consultation systems could be highly valuable.

In the spirit of cross-border communication and consultation, panelists highlighted existing and newly established crisis management groups as a way to support open communication. The FSB Key Attributes describe the crisis management groups as a means of facilitating ongoing communication. Panelists agreed that such groups should meet frequently. One panelist noted that these groups could be instrumental in reaching global agreement on acceptable resolution tools.

Finally, participants discussed cross-border recognition and enforcement of resolution actions. One panelist noted that the FSB has recently issued guidance on this topic. Another participant noted that much of the existing guidance on crisis management groups is for banks, but it can be extended to CCPs. Panelists agreed that there is significant room for additional guidance and that global coordination on issues related to resolution plans for CCPs is critical.

### Conclusion

From the keynote address to the final panel, the conference focused on a number of critical themes in CCP resolution. While many jurisdictions have some form of existing legislation or guidance that would allow for the resolution of a CCP, this guidance is largely incomplete, untested, and not harmonized across domestic authorities, let alone international authorities. Conference participants called for "fire drills" to test existing operational and legal frameworks for CCP resolution. The actions to be taken by a resolution authority need to be clearly communicated ahead of time to avoid the destabilizing effects of uncertainty. Added to all of these considerations, participants consistently acknowledged the political nature of these discussions, as it will ultimately be up to elected officials to sign into law any new legislation regarding CCP resolution.

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<sup>1</sup> See <http://www.kayswinburne.co.uk/articles/ChicagoFederalReserve2015ConferenceonCCPRiskManagementCentralCounterpartyResolution031115/577>.