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CCP resilience, recovery and resolution: key elements of a possible EU framework

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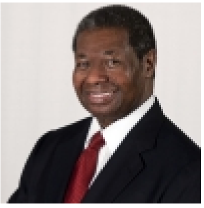

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Objectives of the session

The objective of this roundtable was to discuss the key elements of an EU regulatory framework for the recovery and resolution of CCPs, the level of flexibility or predictability that should be built into the framework, how the availability of appropriate financial resources could be ensured and the possible issues raised by the global dimension of many CCPs.

Executive Summary

Key elements of a CCP Recovery and Resolution (R&R) framework

CCPs had been identified by the G20 as the appropriate financial market infrastructure for concentrating counterparty risk with the implementation of the clearing obligation. There was now a need to provide a framework on how recovery and resolution of CCPs was expected to work. The systemic risks associated with these infrastructures were indeed very high and the impact of a potential failure on the economy could be immense. Moreover, this needed to be a global approach given the international dimension of many CCPs and legal certainty had to be ensured for all stakeholders in the system.

Regulators had withheld action, pending further work in the FSB and guidance from the September 2016 G20 meeting. The European Commission was planning a subsequent legislative approach near the end of the year.

Definitions had to be agreed first because there were different interpretations across jurisdictions.

Resolution meant finding a way to preserve critical business functions with a financial reconstruction in order to allow the systemic functions of a CCP to continue. Public support was not an option.

The protection of the financial system and its constituents in the event of a CCP stress required a toolbox, something which needed to be clearly stated in the rules. It was suggested that recovery tools should be favoured at first instance given the objective of continuity. They also needed sufficient transparency regarding the recovery plan and there should be clarity and alignment of the incentives of shareholders and clearing members in order to ensure an appropriate resolution of the failure. Prudential and market supervisors moreover should be required to work together in order to avoid conflicts regarding clearing members in particular. The suggestion was also made that a solution needed to be worked out for non-default losses i.e. those that were unrelated to a clearing member’s default, as there was still uncertainty as to who should bear the losses in such a case; it should be shareholders, a panellist suggested, but equity might also have been wiped out.

Ensuring that appropriate risk governance was in place was another important issue. Members wanted a forum to enable them to put forward their views, from a membership liability perspective, on clearinghouse rules and risk management frameworks, as they provided a large part of the capital. There were rules under EMIR, but some felt that they were not always appropriately applied in the CCPs' risk committee. Representatives from clearing members and clients sat on CCP risk committees but they just supplied market expertise, and were not supposed to speak in their organizations' interests. Many clearinghouses did not take their member feedback seriously enough but some CCPs are engaged regularly with their members and are very much user-orientated, some speakers considered.

Another issue was defining who the decision-makers were and how they interacted with the other stakeholders in a recovery and resolution process.

The nature and the role of the resolution authority in particular needed clarification. One speaker suggested that the resolution authority should be the local authority supervising the CCP on a day-to-day basis because it was the only one able to understand how the CCP worked and to anticipate how markets would react. Another speaker however suggested that there should in any event be a clear division of roles and responsibilities in that case, and in the cases where a CCP was supervised by a college, such as European cross-border CCPs, resolution should be conducted by a resolution college that would be narrower in order to facilitate coordination.

The resolution authority came in at the resolution stage and the EU Parliament had recommended that there should be oversight by public authorities when end-investor money was involved. It was suggested by several speakers that the resolution authority also needed to be involved in the recovery stage, given that recovery would be a fast process and the authority needed to be well-informed of the situation. Moreover there was merit in an early intervention while resources were still remaining, in cases where a recovery was destined for failure, although this was difficult to predict and it could be unhelpful to intervene prematurely in some cases.

Flexibility vs predictability of the CCP R&R framework

Some panellists were in favour of limiting flexibility in the R&R process and ensuring a presumptive path as the most predictable way possible.

Predictability in resolution was very important because at that point all stakeholders would need clarity on where the process was heading, what resources would be used and how the continuity of the CCP could be managed. Clearing members were favourable to predictability, a panellist stressed, because they needed to know upfront what were their financial exposure and liabilities and to be able to plan operations, given that there would be multiple issues to face in the event of a CCP failure i.e. closing bilateral exposures, bidding on auctions in several markets, etc… Shareholders and asset holders also wanted to know what would happen and what they would be liable for. Moreover predictability was important for incentive reasons, because the market would internalise the risks of failure thereby diminishing the risk of failure. Finally, resolution involved interfering with property rights and if resolution authorities did not follow a contractual order in loss allocation for flexibility reasons, they might face legal proceedings and the threat of successful compensation claims under the 'no creditor worse off' safeguard.

Other panellists were in favour of more flexibility. It was indeed very difficult to know what to expect in advance because all defaults were different and in severe crises a rulebook could only be used to a certain extent, before specific thinking was needed. Transparency regarding the waterfall and the obligations of the different stakeholders was however essential.

A balance had to be struck between flexibility and legal certainty, a speaker emphasised. There were various reasons why flexibility was important. The toolbox of measures needed to reflect the differences among CCPs and had to be broad enough to adapt to different liquidity situations in the market and different crisis scenarios. At the same time there had to be legal certainty for supervisors; in addition investors and asset holders needed to know what would happen. Also, there should be no conflict between the actions of prudential and market supervisors, that otherwise might prevent clearing members from participating in the resolution process.

One speaker understood the benefits of a fixed order of loss allocation in resolution in particular but stressed the importance of having appropriate incentives in order to prevent manageable situations from becoming crises. A key to success was in incentivising the clearing members who were crucial for the resolution of the CCP to behave in an appropriate way and to participate in the auction process, if one was needed. This required the incentives to be carefully thought through. For example, if a resolution strategy led to clearing members regaining control of a CCP that had been demutualised, through the provision of equity to members that absorbed losses in resolution, this could influence their behaviour earlier on in the process. Another issue was having the appropriate capital and leverage ratios that would allow members to bid on the defaulting member's portfolio. Predictability and transparency about the order of loss allocation could be beneficial in this case provided the incentives were well-aligned.

Ensuring the availability of appropriate financial resources

Where the question of predictability really arose was regarding financial resources. If the two largest net debtors defaulted, there had to be sufficient aggregate financial safeguards to cover the losses. The resolution discussion had reached a tough position because CCPs had been required to implement comprehensive loss allocation rules, meaning that the losses would have to be absorbed by the market right down to the end of the waterfall, with less attractive tools as they moved further down.

The question was where resources would come from and to what extent they needed to be pre-funded Implementing a resolution fund and TLAC was challenging because they were difficult to scale and involved additional costs. A speaker felt that asking CCPs to pre-fund resources on top of defaulter margins and Cover 2 requirements (the EMIR requirement that total financial resources should cover the default of the two largest members) would challenge their business models and lean against incentivising central clearing. An option for ensuring that adequate resources would be available for resolution without requiring additional pre-funding might be to reserve parts of the waterfall for the potential use by the resolution authority. They could incorporate a final cash call in the recovery plan or tools such as variation margin gains haircutting or partial tear-ups of trades, subject to discussion with the resolution authority. It was also suggested that the clearing members should receive equity in return for contributions to the resolution cash call. However, another speaker considered that this approach would lead to re-mutualising the CCP and needed further thought; if equity was wiped out it should be in favour of new money. Another issue was that these tools impacted end-users and this would be a situation left to management discretion; it was therefore be preferable to have that under resolution, a panellist suggested.

Whether an exposure to a CCP was capped or uncapped was also a critical issue for clearing members, who were asked by their regulators to measure risk ex ante if they were joining a clearing house that had the potential for uncapped liability. This was the case for some CCPs, where members had to cover remaining losses that exceeded the guarantee fund for the CCP to continue its operations. In many other CCPs however there was a cap on a single default, for which the guarantee fund could be used. What happened in this case if the breakdown was more systemic and if more than one clearing member defaulted was however unclear, because clearinghouse approval was necessary for a member to withdraw and members were subject to a continued replenishment obligation of the guarantee fund over a period of time. Having the market provide large cash calls at a bad time was procyclical. Therefore the best way to arrange financial resources, in terms of market stability, was to have a capped structure as standard, a speaker stated.

International Coordination

The delay of European legislation until the end of the year to allow international standards to develop was applauded. The prospects for success were far greater when everybody reached a degree of consensus around international standards at the start, and were held to them, rather than engaging in lengthy equivalence processes.

They however faced the challenge that laws were made nationally and decisions were made by local authorities, while the financial system was global, markets were interconnected and many CCPs had a global dimension and shared the same clearing members. Outcomes had to be delivered that worked for all jurisdictions when they faced a stress event, but they did not yet have an appropriate answer for that, a speaker believed. Barriers had been created between financial systems because it had not been possible to reach reliance and trust. Although the framework should work for both the home and host countries of a cross-border CCP, the issue was not to protect a specific country but the whole financial system, another speaker emphasised, this was a global issue. Another challenge was that business could move from one CCP to another and potentially concentrate in the weakest point in terms of regulation, which would threaten stability.

Establishing a minimum set of common standards at the international level, such as those defined by the FSB and CPMI-IOSCO, was a necessary starting point to address these different issues. There was however still the issue that laws were local and would be applied by local authorities, a speaker stressed.

Moreover prudential and market supervisors needed to be brought together in the event of a CCP resolution in order to avoid contradictions between them. This required knowing where the possible barriers were, e.g. regarding clearing members that may be located in different jurisdictions, and pre-planning in order to have enough legal certainty.

Detailed Summary

1. Key issues to be addressed regarding CCP Recovery and Resolution (R&R)

CCP R&R framework objectives and update

The G20 had created the clearing obligation. The CCP had been chosen as the focus for concentrating counterparty risk, and therefore there was an obligation to provide a framework to manage a possible recovery or resolution in case of default. The systemic risks associated with these infrastructures were indeed very high as well as the potential impacts on the economy in case of a failure. It was not just a European issue; there were many global players and they needed to find a way for it to work, so that there was legal certainty for everybody in the system.

Work was being conducted in Europe and other jurisdictions to develop a CCP R&R framework, a policy-maker explained. The European Commission had announced a legislative project towards the end of the year. It was a truly international issue and the stakes were high: € 64.7 trillion in gross notional contracts and several systemically important CCPs.

A public representative noted that the thinking and understanding about CCP R&R in Europe had been completed since the report produced by the EU Parliament in 2013. The FSB had also produced significant work on this issue, the outcome of which would be seen at the September 2016 G20 meeting.

Key elements of a CCP R&R framework

A public representative emphasised that the conditions for ensuring the stability and on-going business of a CCP needed to be clarified as well as definitions. There were different interpretations across jurisdictions. For most CCPs, resolution meant that they had to find a way of maintaining the clearing function and operations of the entity in order to allow the market to continue operating and ensure market stability. Resolution was a financial reconstruction to allow the systemic functions of a CCP to continue, a regulator added. The journey between the end of resilience and the beginning of resolution would probably be short, because the tools that were available in the recovery phase would either work immediately or not at all.

A regulator stressed that CCPs were not banks and could not be looked at in the same way. It should be clarified that 'resolution' should not be understood in the same way as for banks. There were many banks always ready to take over if a bank failed, but there were few CCPs.

Another regulator however disagreed with the idea that the resolution of banks and CCPs were unrelated. Continuity of systemic services drove bank resolution also. When they resolved banks they needed to maintain the critical economic functions so that they could continue. As for CCPs, temporary public support was not an option, as that would place the burden of a CCP or bank failure on taxpayers rather than market participants and creditors.

Another issue was the toolbox that should be used for protecting the system and individuals within it and the related incentives. In resolution, the first objective was to keep the business running, because the market needed it, a regulator emphasised. That meant using recovery tools as much as possible and the recovery tools needed to be clearly stated in a rulebook and they needed to be clear on where the functional responsibilities were. The incentives also needed to be clear for shareholders and clearing members e.g. not to go unnecessarily into resolution. Different types of losses needed to be covered in the plan, and the recovery plan needed to be as transparent as possible. A public representative added that it was important that prudential and market supervisors worked together in this perspective in order to favour stability; this was the case in the context of the FSB work. Ultimately, if prudential and market supervision were in conflict, the system would become unstable going forward.

An industry representative considered that there was not enough focus on non default losses i.e. losses that were not related to a clearing member default. Those conversations had just started and those issues were hard to quantify and assess. An industry solution was needed. There was uncertainty on who would bear the losses of non default loss. The speaker believed that it should have been shareholders, but there was also uncertainty on what to do if equity was wiped out; and that needed to be clarified.

2. Flexibility vs predictability of the CCP R&R framework

The panellists debated to what extent the CCP recovery and resolution process and framework needed to be flexible as opposed to predictable or following a presumptive path based on a fixed order of loss allocation.

Some participants were in favour of predictability and limiting flexibility.

A regulator stated that during recovery they would know very quickly whether it would work and whether the defaulting members' positions could be auctioned off. If they could not, they would quickly move into resolution. At that point, they needed clarity on where they would go, what resources they would use, and how they could manage the situation with the CCP. Resolution planning helped to ensure that there was predictability around how the resolution worked. Having predictability for clearing members as to where they would be and when resolution would happen was important. That seemed the most promising way forward because if they ever faced the eventuality of the two largest clearing members and multiple CCPs having failed, there would be lots going on.

In terms of benefits of resolution, they had done it for banks and wanted it for all systemically important financial institutions, to reap the benefits of lower probability of default. Predictability about how losses would be allocated was also important for incentive reasons, so that the market internalised the risks of failure. Enterprises that internalised the cost of failure made them less likely to fail, which was why they needed to address the resolution question upfront and have a credible resolution path, and resources for it. If they left it to chance and flexibility, or hinted that public money would be involved, they would not get the discipline in the CCPs.

Moreover resolution authorities had powers to interfere with people's property rights. They only had those powers with creditor safeguards, which involved delivering an outcome no worse than would occur in insolvency. The problem with CCPs was that loss allocation rules had to be comprehensive. That meant that the loss would have to be absorbed by the market right down to the end of the waterfall, with less attractive tools to deploy as they moved further down the waterfall. If a resolution authority hit liability holders in a different way than what was planned for flexibility reasons, the holder could respond that there was a contractual order in which losses fell, that order had been abused, and thus they would pursue compensation.

An industry representative emphasised that predictability and transparency were critical for clearing members who relied on recovery rules. They indeed needed to understand when they could be called for replenishing default funds, how many assessments they were liable for, or at what point the gains on their variation margin could be taken from them. They knew the details of the waterfall and they evaluated the way it was measured, its predictability and the level of transparency.

Moreover, many things would happen simultaneously if the two largest clearing members of a CCP defaulted, so they needed transparency and predictability. These would be two of the largest banks in the world going down in multiple clearinghouses, the industry speaker stressed. When they reached that point, there would be many other things going on in the market. Clearing members would be looking at all of their bilateral exposures and how they would close them. They would be bidding on the auctions in all of those markets. They would also be seconding traders and would also be asked by the clearinghouses to provide hedges to be able to manage their portfolios.

Several panellists were in favour of some flexibility.

A regulator was in favour of flexibility. CCPs were more like nuclear waste sites than power stations. In financial terms, if they concentrated their risk in one place they had to be careful about how they oversaw that place. That was a major point for the stability of the system. That was why flexibility was needed in the process and the tools, especially in the resolution stage. In recovery the emphasis was on transparency; in resolution it was on flexibility. He agreed that resolution authorities needed to known who they were dealing with. However, they needed flexibility in the end because they never knew what to expect. In serious crises the rulebook typically only worked to an extent.

Flexibility was also welcomed by some industry representatives. The example of DTCC was illustrative: it had managed 44 defaults and much flexibility had been needed because no defaults were the same. The speaker however believed in transparency and ensuring that everybody understood the waterfall and the related obligations. CCPs were not banks or set up as banks, nor did they take on principal risk. They focused on and managed the risks that their members brought to them. In the case of equity CCPs, like DTCC, they did not have a portfolio that they were going to auction off to their members. Theirs was a three day risk, so all they had to do in a defaulting member’s case was hedge their positions and then liquidate those positions out. They did so with their members.

A regulator saw the benefit of predictability and of a presumptive path, as regards the order of loss allocation; however he was more on the side of flexibility. In a presumptive-path approach incentives had to be carefully thought through and aligned.

If there was a stress situation in a CCP which led them through recovery into potential resolution, the key to success was incentivising the clearing members to behave in an appropriate way. Typically, when the first clearing member defaulted, the CCP then hedged the risk and auctioned it off to remaining non defaulting members. If one took the presumptive path approach, they needed to ensure that the incentives had been thought through so that the clearing members whose behaviour was critical to the success of the auction process would be present and would participate in the auction. For example, a resolution strategy involving equity exchanges that could lead them to regain control, economic ownership, or governance of the CCP that had been demutualised some years ago, could influence their behaviour earlier on.

There had also been talk related to capital and leverage ratios. A concern was whether, in the event of a default of the first member and subsequent auction process, the other members would be able to bid on the defaulting member’s portfolio or whether they would be unable to take it on, which would end with a manageable default resulting in contagion. He saw the benefits of a presumptive path and transparency in this case, but the incentives had to be carefully aligned, and the system had to allow other members to bid on the portfolio to prevent manageable stress situations from becoming contagious crises.

A speaker argued for a balance between flexibility and legal certainty.

A public representative explained that there was a balance to be struck between flexibility and legal certainty and they had to recognise that not all CCPs were the same. The toolbox needed to reflect the differences. Flexibility in policy terms meant using the appropriate tool for the appropriate institution. They had to ensure that the toolbox was broad enough, but defined for the appropriate institutions and scenarios.

There were various reasons that one may have wanted flexibility. They needed the flexibility of the right tools for the right institutions and occasions, as every CCP had a different setup. Liquidity in the market would also dictate which tools were appropriate; they needed different tools to be available if liquidity in an asset class was suddenly lost.

It could be assumed that if the two largest members were defaulting then regulators, central banks and everyone else would be heavily involved. They needed to know who would be involved, when, and what they would be doing in various situations. For example the consequences of a cyberattack might need to be managed in a specific way. If it were an operational issue caused by a management failure, then they would need another team that could take over.

At the same time there should be legal certainty. Prudential and market supervisors needed to know where they had legal certainty to step in. They should know in advance where the sticking points for legal certainty were. They needed to ensure that investors and asset holders knew with some certainty what would happen and what they would be liable for. The prudential side should not contradict the market side when it came to cash injections coming via the banking sector. Those clearing members were typically the largest banks. One should not reach a point where prudential supervisors would hinder the process because there were breaches with capital requirements.

3. Ensuring the availability of appropriate financial resources

A regulator emphasised that where the question of predictability really arose was on the question of financial resources. They were currently in a bind in the resolution discussion because they had required CCPs to implement comprehensive loss allocation rules.

From a resolution perspective, there was the question of where resources for resolution came from and to what extent they had to be pre-funded. The challenge with a resolution fund and TLAC was that they were hard to scale, given the associated cost. Defaulter margin and Cover 2 requirements were already demanding. Adding pre funded resources on top would challenge business models in CCPs if those resources were to be remunerated in some way, and would lean against the incentives for central clearing.

Another question was how to obtain the necessary resolution resources. One way to ensure that adequate resources would be available for resolution without requiring additional pre-funding was to reserve parts of the waterfall for the potential use by the resolution authority. A final cash call or subsequent tools such as gains haircutting, tear-up or loss allocation could be in the recovery plan, but given their potential consequences for financial stability, would be applied by the resolution authority (unless the resolution authority determined that the situation was not systemic and released them for use by the CCP). That would sharpen incentives for recovery to work. If auctions did not clear and auction prices suggested losses dipping into that cash call, people would understand that the resolution would be commencing. Given the length of waterfalls, the incentives were powerful enough to make recovery work; however part of resolution was ensuring that equity holders suffered losses. He therefore suggested that if that last resolution cash call was engaged, the clearing members that contributed to it should receive equity in return.

A regulator was concerned that the last round of assessments would be converted into re mutualising the clearinghouse. He thought that there needed to be further discussion around whether that was the right thing. He agreed that at a certain point they would wipe out the equity, but it should have been in favour of new money. There were issues that needed to be thought through and things needed to be balanced.

An industry representative explained that clearing members spent a lot of time trying to figure out whether their exposure to a clearinghouse was capped or uncapped. The challenge with the idea of comprehensive loss allocation was that the market needed to absorb the losses; the question was how to measure and manage that, ex ante. From a prudential, regulatory, and safety and soundness perspective, their regulators required them to be able to measure risk and get approval ahead of time when they joined a clearinghouse that had the potential for uncapped liability.

For some clearing houses it was clear that it was a bottomless pit, which meant that members would have to cover the remaining losses if there was a loss that exceeded the guarantee fund, for the CCP to continue its operations.

For many other clearinghouses regulators said that there was a cap on a single default and that the guarantee fund could be used for that. The problem however was what happened if the breakdown in the market was more systemic and led to multiple defaults; it was not certain that it would be possible for members to withdraw from the market in a reasonable period in such a case to cap their losses. In many cases this would not be possible, the speaker believed, because clearinghouse approval would be needed.

The example of a clearing house was given where, upon a default, clearing members had a call for one assessment and had to replenish but they did not know how much. They were in a period where they could not withdraw. If there had been more defaults they would have been in a cycle where they continued to replenish and provide assessments. There were no capital or liquidity requirements in these assessment calls. Having the market provide cash calls at a bad time was procyclical; so the way they would see financial resources, in order to ensure market stability, was having a capped structure that was very standard, even at a global level where they had a guarantee fund and would be liable for an assessment over a defined time period.

In an environment in which two members were going down if the auction failed and after the assessment was utilised for a default and if there were still not sufficient resources, that was a point of non viability. Using tools like partial tear up of trades or variation margin gains haircutting meant that end users were impacted because the trades of the defaulting member’s portfolio could not be liquidated at a fair market price. It would be preferable to have that under resolution, otherwise it would be a situation where those tools were left to management discretion.

An industry representative quoted a speaker who had advocated a First Do No Harm approach in another session of the Eurofi Amsterdam seminar. He thought that that principle was important and that they should conduct careful analysis before setting out principles. He stated that no two CCPs were alike; they looked at very different marketplaces and had very different governance structures.

4. Risk governance within CCPs and resolution authorities

Risk governance

A regulator emphasised the importance of governance issues. There were rules for that under EMIR and the US regime. There were a finite number of tools to deal with those situations, but the issue was who the decision-maker was, who stepped in, and when. Clearly the self preservation of the interests of management and equity holders, and the systemic stability interests of market regulators or resolution authorities were different. Governance was important as they continued to discuss those issues in international fora.

An industry representative suggested that the industry needed a forum to be able to provide their views on clearinghouse rules and risk management framework because they were providing a large share of the capital. Under EMIR, clearing members and clients needed to sit on CCP risk committees. That role did not represent member interests; clearing members were acting as market experts there to advise the clearinghouse. Some clearinghouses took their feedback seriously, but many did not. That was an area that needed improvement. The Bank of England had focused on that, had set a path to enhance CCP risk governance in the UK, and had focused on leveraging the market expertise, advising clearinghouses to engage members and listen to their feedback. That needed to be incorporated in board level decisions.

In the example of DTCC, the governance structure was user owned, user operated and user managed, therefore they had all of the things that they had spoken about in governance, another industry speaker stressed. They were aligned top to bottom: their users were their shareholders; their shareholders were their board members; and their board members sat on their committees. They decided what their services were, sat on their risk committees, and decided what services they were involved in, what products they would offer and how they would risk manage. They were constantly spoken to about the issues.

Resolution Authorities

A public representative emphasised it was also important, as the 2013 report of the EU Parliament had concluded, that if end investor money was involved there was oversight by public authorities on how the money was distributed and how end-investors were affected. That principle would continue through the Parliament’s work when they began at the end of the year.

A regulator outlined that the public authorities came in at resolution but a further element of success would be for resolution authorities to be involved in the recovery stage. They needed to know what was going on because they could be called in very quickly. Supervisors could consider also the possibility of temporary public intervention to prevent a financial system meltdown, which they were all trying to prevent. Another regulator however disagreed, as this would mean using taxpayer money albeit temporarily. The other regulator continued that they never knew what to expect, so communication needed to be very clear. Organisation wise, they had some experience in Europe of working in colleges of supervision, since many of the CCPs operated across national boundaries and there was the possibility of cross boundary ripple effects. The cooperation already taking place needed to be carried over in resolution organisations or colleges, which should not be as wide because there was not as much time for coordination in emergency situations.

An industry representative agreed that the phase between recovery and resolution would indeed happen quickly, and they would prefer that the resolution authority stepped in early because it would be problematic for the market if auctions did not work and trades could not be liquidated at a fair market price.

A regulator thought that there was merit in the notion that, in a recovery destined for failure, the resolution authority intervened while there were resources remaining. This was difficult however because every crisis was different, so they would not know whether the recovery was doomed. There were also risks around intervening prematurely before a recovery that may have been successful.

Another industry representative felt that the resolution authority would need to be the local authority because other possible public resolution authorities did not understand how CCPs worked. Those who understood the obligations of CCPs and how they worked were the day to day regulators, such as the securities regulators i.e. the CFTC and the SEC in the US. It would have been dangerous to put resolution authorities that did not understand how the markets worked or reacted into a situation that they did not understand.

5. International Coordination

Progress had been made in the international coordination regarding the CCP R&R framework, a regulator believed. The EU Commission had previewed aspects of the resolution legislation that was being developed to regulators in other jurisdictions. The fact that the Europeans had delayed the completion of legislation until the end of the current year, so that international standards could merge and develop was welcomed. The approach currently being taken in developing international consensus around important issues and embodying it in legislation was commendable. The prospects for success were far greater when everybody reached a degree of consensus around international standards, and everybody was held to them. The equivalence process around EMIR had indeed taken three years to complete and an enormous amount of resources.

An industry representative advised that the Key Attributes tailored for Financial Market Infrastructures (FMIs) gave sufficient guidance and provided a very good starting point at the international level. The Key Attributes looked directly at what an FMI was and tailored the resolution authority to that. Local authorities should decide how the resolution would take place. In the US, it would be the US authorities in US courts that would make the decision about what would happen. It would have an international effect, but they had to deal with the reality that all laws were local, and not international. Whilst they were all interconnected, all laws were local.

A regulator agreed that all decisions were local, but noted that in a lot of cases they were dealing with potential competitors across the world. The business and financial worlds could easily move from one CCP to another, following regulatory change, depending on convenience. That could be an issue that they had to deal with in Europe. If they had a minimum set of standards in regulation, they would know where they were. If they did not, business would flow to the weakest point in terms of regulation, which would weaken the system. The local environment that could handle the local financial system may not have been able to cope with the business coming from elsewhere. The reason behind the CPMI IOSCO principles and the attempt to reach a minimum common standard had been to prevent that from happening. To an extent, that would weaken the power of local authorities, but that was unavoidable in a globalised environment.

The industry speaker agreed and thought that the work conducted by the FSB and the CPMI IOSCO was fine and was something they needed to focus on. However, even when they had a lowest common denominator of international rules, local rules would be decided by local authorities. That is what they had seen in the crisis.

Another regulator outlined that the challenge was that laws were made nationally, but they had an interconnected global financial system and somehow needed to deliver outcomes that worked for both home and host. A recurrent theme throughout the conversation had been that they shared the clearing members across the global CCPs in common. They had to consider how they would deliver an outcome that worked for all jurisdictions when they faced the stress event.

They did not currently have a response. They had created barriers between financial systems because they had been unable to reach mutual reliance and trust. He suggested that one of the lessons from the financial crisis was that they had not kept financial stability and legal frameworks up to date; and a merit of the Commission's work was that there was thorough conversation in Europe about what was needed for recovery and resolution of CCPs in terms of the legal environment. He thought that the US would have been the beneficiary of that, insofar as European CCPs were consequently more stable.

A public representative commented that all law was local unless it was an EU regulation, so they had to work in a cross border way. It was about protecting the system, not the host. They were discussing global institutions and needed to address global issues. They needed to bring prudential and market supervisors together to discuss the resolution of individual CCPs to know where the barriers were for participating at various stages, using different tools. If a prudential regulator in one country was going to put up barriers to participants, and the largest members happened to be from that country in another jurisdiction, they needed to know in advance. The issue was of pre planning, knowing where barriers were and putting legal certainty behind the tools that would be used at any point. They could not plan for every eventuality, but could plan for a significant number of them.

Conclusion

The chair outlined that there had been three conclusions reached by the panel. There was agreement that they needed to balance predictability and transparency with flexibility in dealing with extreme tail end events with incentives coming from that flexibility, different company structures and a presumptive path as regards the order of loss allocation.

The second area of agreement was that on resolution and resources, authorities should have been able to step in during the recovery phase, before they ran to the end of the waterfall. He noted that there had been a suggestion to look into a tool to make resources measurable, predictable and manageable for the clearing members, which they needed to consider further.

Thirdly, international effects were important, but the laws of nature had been turned on their head; laws of gravity did not apply to CCP recovery and resolution. They really needed to take into account the suggestion that decisions were local, but resolution authorities and decisions had international impacts.