Regulatory brief

A publication of PwC's financial services regulatory practice

September 2013

Systemically important derivatives clearing organizations: The CFTC proposes recovery and wind-down plans

Overview

Last month, the Commodity Futures Trading Commission (CFTC) proposed amendments to its Derivative Clearing Organization (DCO) regulations in order to heighten regulatory standards for systemically important DCOs (SIDCOs). A SIDCO is a type of Systemically Important Financial Market Utility (SIFMU) that is registered with and regulated by the CFTC.[1]

The fairly complex CFTC proposal is significant for several reasons, but the following two are worthy of particular focus:

- First, the CFTC proposal allows US DCOs that have not been deemed as systemically important to opt-in to the SIDCO regulatory regime in order to allow global banks that trade through US DCOs to qualify under Basel III for lower capital charges (i.e., the proposal allow a US DCO to be considered a "Qualified Central Counterparty" (QCCP) under Basel III).[2]
- Second, the proposal requires SIDCOs to maintain "viable" recovery or orderly wind-down plans.

The first point is important because under Basel CCP Capital Requirements, a much higher risk-weight is imposed on derivatives that are cleared through CCPs rather than QCCPs. As a result, global banks will be incentivized to trade through QCCPs, thus placing US DCOs that operate internationally (but are not QCCPs) at a "substantial competitive disadvantage" to foreign QCCPs.

Regarding the second point, as recently stated by the International Swap Dealers Association (ISDA), the primary goal for CCPs should be recovery and continuity rather than resolution. For that reason, this brief will review the CFTC proposal in light of two other documents also released in August which focus on recovery and continuity planning, namely: *Consultative Report: Recovery of Financial Market Infrastructures* published by CPSS-IOSCO[3] (IOSCO Report) and *CCP Loss Allocation at the End of the Waterfall* published by ISDA (ISDA Paper).

---

[1] See PwC's *Financial Services Regulatory Brief: More Scrutiny for Financial Market Utilities* (May 2013) which describes the Financial Stability Oversight Council's (Council) designation of eight FMUs as SIFMUs under Title VIII of Dodd-Frank and notes the "Supervisory Agency" for each SIFMU. The Chicago Mercantile Exchange, Inc. (CME) and ICE Clear Credit LLC (ICE Clear Credit) are CFTC-registered SIDCOs, for which the CFTC is the Supervisory Agency. The Options Clearing Corporation (OCC) is dually-registered with the CFTC and SEC which is its Supervisory Agency.

[2] In July of 2012, the Basel Committee on Banking Supervision (BCBS) published *Capital Requirements for Bank Exposures to Central Counterparties* (Basel CCP Capital Requirements) as part of Basel III, which calls for banks to hold capital due to exposure to central counterparties (CCPs). In July 2013, US regulators issued rules adopting Basel III capital standards including the Basel CCP Capital Requirements.

pwc

The IOSCO Report provides international guidance to Financial Market Infrastructures[4] (FMIs) on the development of comprehensive and effective recovery plans. The ISDA Paper seeks to reflect the consensus view of ISDA's Risk and Margin Regulatory Implementation Committee for a "best practice" approach to a CCP "end-of-the-waterfall"[5] situation arising from clearing member defaults and Non-Default Losses (NDL). When viewing these three proposals together from a recovery/continuity standpoint, the key takeaways are the following:

- **Governance**. The CFTC proposal requires that SIDCO governance arrangements assign responsibility for implementing recovery and wind-down plans. The IOSCO Report goes further, however, by being more specific and directive. It indicates that not only should the plan be endorsed by the FMI's board of directors, but senior executives should take more ownership and be more accountable.
- **Scenarios and triggers**. The CFTC proposal requires a SIDCO to identify scenarios that may prevent the SIDCO from continuing its critical operations and services as a going concern, and to assess the full range of options for recovery. The IOSCO Report agrees with the CFTC proposal and agrees that two broad categories of scenarios exist, which we describe as "Membership-triggered" and "Management-triggered." Choosing between these two categories is important for prioritizing recovery tools: Membership-triggered scenarios would start with member resources (e.g., default waterfall, assessment powers, etc.) and Management-triggered scenarios would begin with owner resources (e.g., shareholders equity, debt "bail-ins," etc.).
  - Within Membership-triggered scenarios, the ISDA Paper advocates Variation Margin Gain Haircutting (VMGH) as a robust recovery and continuity mechanism (further discussed below) to operate as part of the default waterfall for CCPs following the exhaustion of all other layers of the default waterfall.
  - Within Management-triggered scenarios, the CFTC proposes its own definition of "general business risk" for which management is responsible – namely, the scenario where expenses exceed revenues, compromising the FMU's financial stability.
- **Tools**. Recovery tools and their attributes are discussed in all three documents in terms of selecting the right tool for each FMU. In our view, the challenge will be to design the tool selection and sequence appropriate to each FMU's unique business model. For those SIDCO's subject to CFTC oversight, the CFTC proposal prohibits tools used in recovery from being "re-used" in potential resolution scenarios. This limitation will require the artful choice of tool for recovery versus resolution and a well-documented understanding of when each tool is exhausted.
- **Decision making autonomy**. The autonomy of FMU decision-making vis-à-vis the regulators' role is a final major theme among the three proposals. Transparency, communication, and the timing of regulatory intervention are the key issues. *Ex ante* transparency on the scenarios, tools, and procedures for Recovery and Resolution Planning (RRP) is a common theme with global consensus, as is the view that RRP procedures require a well-articulated communications plan to keep key stakeholders informed (i.e., FMU members/participants, their clients, and their regulators). However, the open area for discussion between FMUs and regulators is to identify the exact point at which regulators should intervene, because the timing of the intervention, if not handled carefully, can compromise the rules used as the foundation for FMU member decisions.

The CFTC proposal has an effective date for its recovery and wind-down rules of December 31, 2013. Several comments filed on the proposal strongly urged the CFTC to postpone the effective date because of the complexity of the proposals and the relatively short window to develop such plans. ISDA requested the CFTC to invoke its extended review process for its proposal which would allow for more time to consider the proposal. Whatever the outcome of these requests for delay, SIDCOs need to begin – if they have not done so already – to develop a plan and project structure to identify the tools and resources for developing suitable recovery and wind-down plans.

This **Financial Services Regulatory Brief** (a) briefly discusses the two key elements of the CFTC proposal and (b) focuses on important global themes in FMU recovery and wind-down planning that have emerged, incorporating the three August proposals and our view of what SIDCOs should be doing now.

---

[3] This proposal was jointly issued by the Committee on Payment and Settlement Systems (CPSS) and by the Board of International Organization of Securities Commissions (IOSCO). See also *Application of the Key Attributes of Resolution Regimes to Nonbank Financial Institutions: Consultative Document* (August 2013) by the Financial Stability Board.

[4] This brief uses the terms Financial Market Infrastructures (FMIs) and Financial Market Utilities (FMUs) interchangeably, as either term is used by differing global regulatory bodies and standard setters.

[5] The "default waterfall" refers to the financial safeguards available to a CCP to cover losses arising from a clearing member default and the order in which they would be expended, while "end-of-the-waterfall" refers to situations following the exhaustion of all such safeguards and where there are non-default losses that exceed a CCP's financial resources above the minimum regulatory capital requirements (e.g., CCP operational failures).

CFTC proposal

Opt-in to SIDCO regulation

Basel CCP Capital Requirements impose significantly higher capital charges on banks (including their subsidiaries and affiliates) that clear derivatives through CCPs that do not qualify as QCCPs.[6] The CFTC proposal provides a mechanism for a DCO that has not been designated by the Council as systemically important to elect to become subject to the provisions of Subpart C (i.e., the DCO may opt to become a "Subpart C DCO" and be subject to the regulations otherwise applicable only to SIDCOs) and, thereby attain QCCP status. The CFTC is also proposing procedures for withdrawing or rescinding that election.

This proposed opt-in to SIDCO treatment for a non-designated DCO is the first time under Dodd-Frank that an agency has provided a means for an entity to opt-in to being regulated as if it were systemically important. A key question raised is whether CCPs regulated by the Federal Reserve and SEC may also be at a competitive disadvantage if they are not QCCPs and, if so, whether the Federal Reserve and SEC have the authority to also extend the type of opt-in provided by the CFTC to the non-designated CCPs that they regulate.

Recovery and wind-down plans for SIDCOs

The CFTC has proposed that each SIDCO and Subpart C DCO (collectively, "SIDCOs" hereinafter) shall maintain viable plans for: (1) recovery or orderly wind-down, necessitated by uncovered credit losses or liquidity shortfalls; and, <u>separately</u>, (2) recovery or orderly wind-down necessitated by general business risk, operational risk, or any other risk that threatens the SIDCOs viability as a going concern.

The CFTC proposes defining "recovery" as the actions of a SIDCO consistent with its rules, procedures, and other *ex-ante* contractual arrangements, to address any uncovered credit loss, liquidity shortfall, capital inadequacy or business, operational or other structural weakness (including the replenishment of any depleted prefunded financial resources and liquidity arrangements) in order to keep the SIDCO viable. The goal is to maintain the SIDCO as a going concern so that it can continue to provide its critical services without requiring insolvency proceedings or the use of resolution powers by the Federal Deposit Insurance Corporation (FDIC) or any other resolution authority. The CFTC proposal asks whether its definition of "recovery" is appropriate in light of emerging international consensus.

With respect to other proposed definitions, the CFTC proposes defining "wind-down" as the actions of a SIDCO to affect the permanent cessation or sale or transfer of one or more services.

The CFTC also proposes defining "general business risk," as any potential impairment of a SIDCO's financial position, as a business concern, as a consequence of a decline in its revenues or an increase in its expenses, such that expenses exceed revenues and result in a loss that the SIDCO must charge against capital.

The CFTC proposal requires that the recovery and wind-down plans of SIDCOs meet certain standards. Specifically, the CFTC proposes requiring a SIDCO to identify scenarios that may potentially prevent it from being able to provide its critical operations and services as a going concern, and to assess the effectiveness of a full range of options for recovery or orderly wind-down. The SIDCO's plans should also include procedures for informing the CFTC, as soon as practicable, when the recovery plan is initiated or wind-down is pending, as well as procedures for providing the CFTC and any other relevant authorities (e.g., the FDIC) with information necessary for resolution planning.

The CFTC proposal mandates that the recovery and wind-down plans of a SIDCO be supported by certain financial resources. Specifically, in evaluating the resources available to cover any uncovered credit losses or liquidity shortfalls as part of its recovery or wind-down plans, a SIDCO is permitted to consider assessments of additional resources that it reasonably expects to collect from non-defaulting members. In addition, a SIDCO would be required to maintain sufficient unencumbered liquid financial assets, funded by the equity of its owners, to implement its recovery or wind-down plans necessitated by general business risk, operational risk, or any other risk that threatens the SIDCO's viability as a going concern.

Under the proposal, if a SIDCO allocates resources, in whole or in part, to execute its recovery plan for uncovered credit losses or liquidity shortfalls, it may not allocate those same resources to satisfy the recovery plan for business, operational, or other risks. In addition, resources may be allocated only to the extent the use of that resource is not otherwise limited by the Commodity Exchange Act (CEA), CFTC regulations, the SIDCO's rules, or any contractual arrangements to which the SIDCO is a party.

[6] A QCCP is defined as an entity that (i) is licensed to operate as a CCP and is permitted by the appropriate regulator to operate as such, and (ii) is prudentially supervised in a jurisdiction where the relevant regulator has established and publicly indicated that it applies domestic regulations to the CCP that are consistent with CPSS-IOSCO's jointly issued Principles for Financial Market Infrastructures (PFMI) released in April 2012. See PwC's *Financial Services Regulatory Brief* described in footnote 1 for more information.

A SIDCO is also required to maintain viable plans for raising additional financial resources, including, where appropriate, capital in a scenario in which it is unable (or virtually unable) to comply with any financial resource requirements set forth in the proposal. These plans would also have to be approved by the SIDCO's board of directors and be updated regularly.

Finally, the CFTC indicated that it would be necessary for a SIDCO to maintain and regularly update its recovery and wind-down plan so as to reduce (or attempt to control) the potential impact that a failure or disruption of the SIDCO's operations would have on the stability of the US financial markets.

Global themes in recovery and wind-down planning

Governance

The CFTC proposal requires that governance arrangements assign responsibility for implementing the recovery and wind-down plans. The IOSCO Report goes further by stating that the recovery plan needs formal endorsement from the FMI's Board of Directors ("Board"). The IOSCO Report also indicates that FMIs are expected to "identify a senior executive responsible for ensuring that the FMI observes recovery planning requirements and that recovery planning is integrated into the firm's overall governance process."[7] Earlier discussions of FMI recovery plans did not specify this level of senior executive ownership and accountability.[8]

This level of recommended oversight, accountability, and ownership will raise the profile of resolution planning at FMIs. To date, we have seen that a subset of FMIs has decided to inform their Board of the need for a resolution plan. Going forward, we believe FMIs should work with their Board to: (1) educate the Board on FMI recovery (and resolution) planning, and (2) propose a recovery (and resolution) planning governance structure (including a responsible senior executive) for Board review. While the IOSCO Report focuses on recovery planning, recovery planning is part of the broader industry discussion of RRP. We believe that DCOs should have a robust discussion of both topics with the Board.

Scenarios and triggers

The discussion of scenarios and triggers for recovery and/or resolution is of particular interest to FMIs. The big question for FMIs is "What else do you want to plan for"? FMIs have already had to contemplate their ability to wind-down as part of their existing rules. The recent publications stop short of identifying new risks that FMIs have not contemplated; rather the IOSCO Report offers six categories to frame the scenarios[9] (although not all categories of scenarios are applicable to all FMIs):

- Uncovered losses caused by participant default
- Uncovered liquidity shortfalls
- Replenishment of financial resources
- Losses not related to participant default
- Need to re-establish a matched book
- Ability to address structural weaknesses

The scenarios have a taxonomy that naturally divides them into two categories: Membership-triggered scenarios or Management-triggered scenarios. The IOSCO Report, CFTC proposal, and ISDA Paper all allude to the scenarios in terms of the resources that should be applied based on the type of trigger: Membership-triggered failures rely on member-resources (e.g., assessment powers, etc.) while Management-triggered scenarios begin with owners' assets (e.g., "bail in," equity interests, etc.).

- Membership-triggered scenarios: The scenarios in this category are the more mature scenarios currently contemplated in FMI rules. The ISDA Paper notes that "end-of-the waterfall" situations following the exhaustion of financial safeguards available to a CCP can arise where:
  - Mark-to-market losses on the CCP's open risk positions exhaust the default waterfall resources prior to the completion of the auction process.
  - The auction settlement price is established, but the price at which the members are willing to assume the CCP's open positions exhausts the risk waterfall.
  - The auction process fails and is unable to establish a market-clearing price.
- Management–triggered scenarios: This category of scenarios aligns with the CFTC's proposed definitions of "general business risk" (separate and distinct from "operational risk"). The definition of general business risk is probably closer to the IOSCO Report's discussion of allocation of business losses, but it is notable that the CFTC has taken the step of explicitly defining the term. In sum, this category will have to identify scenarios driven by financial losses due to an increase in expenses or a decrease in revenues that result in a charge against capital.

[7] *IOSCO Report* at section 2.3.3

[8] See, e.g., *PFMI*, described in footnote 6.

[9] See *IOSCO Report* at section 3.4.3.

Identifying the scenarios (and triggers) is important because it drives the selection of the appropriate recovery tool. The goal is "suitability" – the choice of tool(s) that are suitable for the recovery and/or resolution.

Tools

The tools available in RRP scenarios need to be fit for their purpose. The CFTC proposal sets the standard that RRP tools' financial sufficiency needs to be analyzed and evidenced. The ISDA Paper provides a fact-based case for ensuring that FMIs consider the implications of their tool choice. In its advocacy for CCPs use of VMGH[10] as a powerful and appropriate recovery tool, the ISDA Paper makes clear that alternative tools may have extreme, negative consequences for CCP participants or members. It reiterates the IOSCO recommendation that the tools need to be evaluated to make sure that the FMI understands the implications of the tools and their suitability.

The tools addressed in the IOSCO Report include:

- Assessment powers (i.e., cash calls on members)
- Borrowing funds owed to participants (i.e., loans, swaps or repos)
- VMGH
- Initial Margin Haircuts (for surviving members)
- Third-party liquidity arrangement
- Surviving members liquidity arrangements
- Bail-in (i.e., investors)
- Insurance and/or indemnity agreements
- Incentives for auction participants to accept unmatched contracts
- Forced contract allocation
- Contract termination: Tear-ups
  - Voluntary
  - Compulsory

[10] VMGH is an important example of a position-based loss allocation recovery tool. When haircutting variation margin, the CCP reduces *pro rata* the amount it is due to pay participants with in-the-money (net) positions, while continuing to collect in full from those participants with out-of-the-money (net) positions. Unless capped at less than 100 per cent of the amount owed, variation margin haircutting could be expected to cover comprehensively, reliably and promptly a loss caused by participant default. See *IOSCO Report* at page 19.

Depending on the FMI's business model, the choice of the portfolio of tools is a critical decision in RRPs. Furthermore RRPs will need to consider individual tools and the combination and hierarchy of tool application. It is worth noting that the CFTC proposal specifies that a tool can be used for recovery or resolution – but not for both. This proposed requirement reinforces the need to be scenario-driven. It is our view that these issues will require an advanced understanding of the tools, the point at which a tool is exhausted, and the applicability of a tool to a specific scenario.

The tool selection, application hierarchy, and the point of exhaustion should be actively discussed with FMI membership and, once options are identified, confirmed with the RRP governance structure, including the Board. For transparency, the RRP tools and approach should be articulated in the FMI's rules and procedures.

In evaluating tool "suitability" the IOSCO Report recommends that FMIs consider tools that are:[11]

- **Comprehensive**. How much of the uncovered loss would the tool remedy (may vary by scenario).
- **Effective**. Efficacy is defined in terms of reliability, timeliness, and legal basis. In times of extreme stress, the effective principles focus on ensuring the tool is readily available without numerous encumbrances – in other words, quick and easy.
- **Transparent**. FMI participants need to know *ex ante* the calculation methodology and total amount of losses they may be asked to bear. The transparent principle also covers the need to articulate how participants can manage and potentially minimize their exposure to these losses.
- **Incentive-based**. The goal of providing appropriate incentives is to keep participants, owners, and regulators motivated in a consistent direction towards recovery. Incentives need to be two-tiered – for direct and indirect participants.
- **Minimal in negative impact**. The purpose of RRP is to manage and mitigate the risk of systemic contagion that results from highly interconnected FMIs.

In addition, looking across the various documents about RRP tools – for both financial institutions and FMIs – we recommend that FMIs evaluate the degree to which the application of the tool (stand-alone and/or in aggregate) burdens the participants to a greater or lesser degree than the actual insolvency of the FMI.

[11] See *IOSCO Report* at section 3.3.

The ISDA Paper makes an additional case for understanding the proposed RRP tools in the context of how they alter the certainty of the FMIs rules. This discussion is the very point that the IOSCO Report makes regarding transparency. The ISDA Paper provides the business case for transparency in its recommendation of VMGH as a preferred resolution tool for CCPs (assuming all default resources have been exhausted). The discussion considers the scenarios, the available tools, and the degree to which tools are fit for purpose – with a detailed discussion of the implications of various tools IOSCO mentions (including initial margin haircuts and tear-ups).

Decision making autonomy

One of the most common topics among the three proposals is the tradeoff between FMI management autonomy versus the automatic execution of resolution tools. The answer to this question is exacerbated by the lack of an identified resolution agent for FMIs.

Default management (i.e., a risk management proxy model for RRPs) provides the policy, logic and procedures that the FMI will follow in the event of a participant's default and leaves the execution details to the FMI management's judgment (often with a committee of participants to provide advice). The policy and procedures are signed off by the Board, and are made transparent in the rules and in detailed procedures available to participants. The default approach typically provides a balance of control and management discretion to allow for rapid action in times of heightened stress. The RRP governance structure and the responsible senior executive (discussed earlier) should be addressed specifically in discussions of discretionary RRP responsibilities.

Automated tools (which are more common in disaster recovery models) are designed to respond to a specific trigger with a specific response. Given the expected level of volatility and uncertainty around participant-driven scenarios with the potential to put an FMI into recovery or resolution, we recommend caution with the automatic application of tools for these scenarios. Scenarios that are not member-driven (e.g., mismanagement) may be more appropriate for automated responses (e.g., use of a credit facility). The answer to automated versus discretionary responses will depend on the scenario and the tool. Automated tool applications should be discussed with members, disclosed *ex ante,* and thoroughly tested to ensure all implications (direct and indirect) are well understood.

An outstanding key question pertains to the role of regulators in the exercise of recovery or resolution planning, which largely relates to the decision as to exactly at what point regulators should be involved. The ISDA Paper makes the case that regulators should not interfere until all default resources are exhausted. The IOSCO Report offers a more involved role for regulators – active engagement when it is clear that the FMI resources are insufficient. This broad difference can affect everything from FMI governance during a time of great stress to the degree to which the RRP tools are transparent to the participants.

The IOSCO Report advocates for a well-articulated, explicit and detailed communications plan during recovery (regardless of regulatory intervention). The development of the plan should include feedback from regulators on their role and their expected level of involvement. The regulator's role and exact timing of involvement will play a critical role in the design of RRPs.

The CFTC proposal advocates for active communications at the point at which recovery or resolution is triggered, which makes sense in our view. However, the CFTC stops short of proscribing the actions it would take at the point of communications. We believe that the regulatory response needs to be as transparent as the FMIs plans.

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Alison Gilmore
646 471 0588
alison.gilmore@us.pwc.com

Contributors: Rachel Parker, Stuart Desch, Kevin Pilarski, and Gary Welsh.

To learn more about financial services regulation from your iPad or iPhone, click here to download PwC's new Regulatory Navigator App from the Apple App Store.

Follow us on Twitter @PwC_US_FinSrvcs