

Response to the ESMA consultation paper

Draft RTS specifying the conditions for recompense (Article 20(2) of CCPRRR)

Introduction

The Futures Industry Association (FIA) and the International Swaps and Derivatives Association (ISDA), together with the Associations, represent the largest number of global and national participants in clearing, banking and financial markets. The Associations appreciate this opportunity to comment on this consultation.

This consultation response covers the positions of our members that are clearing members and their clients. The paper does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views expressed herein.

In principle we believe that compensation should be provided to clearing members and end users for all losses suffered in recovery or resolution beyond assessments capped at a reasonable level.

In addition, we believe that CCPs should generally be solely responsible for non-default losses, supported by appropriately sized regulatory capital requirements. It is generally not appropriate for clearing members or end-users to cover these NDLS since they are not responsible for the management of the choices that led to any losses. Please see our paper "[CCP Non-Default Losses](#)" for more details.

As ESMA alludes to in the consultation paper, Article 20 describes a very narrow and unlikely situation: For compensation under this article to be paid, a CCP would have to use variation margin haircutting (VMGH) in a non-default loss (NDL) situation which is not part of the rulebook and is applied voluntarily by some clearing members.

In most cases, VMGH is not the appropriate tool to deal with NDL. We are concerned that this article and the RTS detailing it will cause CCPs to consider adding VMGH to their rulebooks to absorb NDLS to avoid ever needing to provide compensation.

Questions

Q1 Do you agree with the proposed order of payments for the recompense to non-defaulting clearing members, i.e. where a contribution made closer to the non-default event would qualify as a senior ranking contribution and result in a senior ranking claim?

In this draft RTS, ESMA proposes to create senior ranking claims for those members that voluntarily pay within the first few days of the payment request. Only once those senior ranking claims have been paid in full will any further group of members (or clients) be recompensed.

We do not believe that speed should be the determining factor here and understand the level 1 text to mean a traditional creditor hierarchy, not the introduction of a new hierarchy. Any member/client that contributed towards absorbing such NDL should have a pro rata and pari passu claim and therefore without any seniorization.

Such a proposal would also disincentivise members who might have participated in loss allocation but are concerned that they will be juniorized because they might not be first. This article covers voluntary loss-allocation and therefore should not introduce disincentives for members to participate.

To make the loss allocation effective, the clearing members' client accounts would need to be involved, or at least clients be given a chance to participate in the loss allocation, as such voluntary loss allocation would only work if many firms (clients and clearing members) participate. Given the voluntary nature of the loss allocation under consideration here, there is realistically no way to determine what each client wants without discussing with them. The clearing member solely assuming that clients would or would not participate might open the clearing member to the risk of litigation. Communication with many clients and agreement whether they participate or not will take time. With a seniorization scheme that penalises firms that involved their clients in the discussion, outcomes in terms of participation could be much lower compared to giving clearing members time to arrange participation.

Also, if early participation would be incentivised, there could be clearing members who sign up to the scheme because they know from observation of market moves that they will not be haircut at least on the first day, or on the first days.

In addition, we question the effectiveness of this incentive mechanism altogether; If not all NDLs are absorbed, the CCP is still likely to go into resolution. As a result, we believe market participants are likely only willing to have VMGH applied to their positions if they are certain that any and all residual losses will be absorbed and CCP resolution can be avoided. Without such upfront certainty market participants are not likely to submit to VMGH. We recommend that participants are made aware whether there are sufficient members that have voluntarily submitted to this tool and all losses will be absorbed before any actual VMGH be applied. Focus should therefore be on absorption of all losses and not on speed of accepting this voluntary VMGH.

We also ask ESMA for more guidance as how VMGH should be performed in the context of Article 20:

There should be a limit on the number of days and absolute amount, to ensure that losses are not allocated in full to for instance only 2 participants that agreed to be participate in voluntary VMGH without them knowing how many other participants will have also agreed.

There should also be guidance that VMGH is only commenced once a sufficient number of participants have signed up.

Q2 : If you agree with establishing an order of senior payments for the recompense, please consider the following questions:

- a) How long should the “senior period” run for, 1 day/1 week and should this period depend on if there is a sequence of non-default events? Should even more layers of priority be introduced?*
- b) Should senior ranking claims be recompensated in full before other qualifying claims are recompensated? If not, should any other balance between senior and other claims be introduced? If yes, how should it work and why would this be preferable to the proposed priority?*
- c) Do you agree that recompense shall be proportionate to the losses between equally ranking claims and that senior ranking claims shall have the same split between cash and instruments as other qualifying claims for recompense (i.e. not only cash to senior ranking claims and instruments of ownership to other qualifying claims)?*

Please see our response to question 1:

Our responses to your detailed questions:

- a) We don't think there should be a senior period. Any member/client that contributed towards absorbing such NDL should have a pro rata and pari passu claim and therefore without any seniorization. Also, there could be practical issues, for instance communication with clients and what time will be used for the determination when a clearing member has participated in loss allocation: the time the clearing member agreed to participate in VMGH, or the time this clearing members' VM was haircut first?
- b) See above, we don't support the seniorization of some clearing members over others who all participate in loss allocation on a voluntary basis.
- c) We believe that all clearing members who participated in the voluntary loss allocation should be compensated at the same time, with the same split between cash and instruments as other qualifying claims for recompense.

Q3 : If you do not agree with establishing an order of senior payments for the recompense as described in this paper, please explain why? How should a different order of recompense be structured? Should all qualifying recompense claims be treated pari passu?

See our response to question 1: We do not believe speed should be of the essence here and understand the level 1 text to mean a traditional creditor hierarchy, not the introduction of a new hierarchy. Any member/client that contributed towards absorbing such NDL should have a pro rata and pari passu claim and therefore without any seniorization.

Such a proposal would also disincentivise members who might have participated in loss allocation but are concerned that they will be juniorized because they might not be first. This article covers voluntary loss-allocation and therefore should not introduce disincentives for members to participate.

Q4 : Do you agree with the proposed definition of profit for the purpose of the recompense scheme?

Yes, we agree with the definition of profit. Any other approach to define profit could run counter to national accounting regimes and might become very complex.

Q5 : Do you agree with the proposed values for the maximum share of profits and maximum number of years for the recompense to be paid? If not, please explain why.

We appreciate that 10 years represent an appropriate amount of time and compensation should not scare away prospective equity investors of the CCP. However, in order for compensation to be effective in addressing moral hazard concerns it is important that all due compensation is paid. Depending on the scenario – for example the prevailing economic and financial conditions – it could take a protracted period for a CCP to be consistently and materially profitable after a recovery event.

However, there should also be a strong incentive for the CCP to pay all its dues to members and clients and therefore any limit in time might not be appropriate. We propose a sliding scale: for the first 10 years, 70% of profits are available for compensation, but for years 11 to 20 only 50% of the CCPs profits would be available for compensation.

Q6 : If you prefer a different set of numbers for the maximum share of profits or maximum number of years, please explain why you prefer those levels.

Please see our response to question 5:

We appreciate that 10 years an appropriate amount of time and compensation should not scare away prospective equity investors of the CCP. However, there should also be a strong incentive for the CCP to pay all its dues to members and clients and therefore any limit in time might not be appropriate. We propose a sliding scale: for the first 10 years, 70% of profits are available for compensation, but for years 11 to 20 only 50% of the CCPs profits would be available for compensation.

Q7 : For the purpose of setting an order of payment, do you agree with the Option 2 of the cost-benefit analysis, do you agree with the Option 2 of the cost-benefit analysis, if not please explain? Have you identified other benefits and costs not mentioned above associated to the proposed approach (Option 2)?

We don't agree with option 2, but option 1 (not providing an order but paying out compensation on a pari passu basis).

While option 2 could incentivise some firms to sign up quickly to voluntary loss allocation, it will also disincentivise members that take longer to sign up, for instance because their governance processes take longer. Focus should be on the effectiveness of the voluntary tool if insufficient losses are absorbed and the CCP would still go into resolution due to fact that residual losses remain.

Q8 : If you advocated for a different approach, how would it impact the cost and benefit assessment? Please provide details

We believe that option one (no order, compensation on a pari-passu base) would equally incentivise more clearing members to participate in voluntary loss allocation.

Q9 : For the purpose of setting the maximum number of years and maximum share of profits, do you agree with the Option 2, if not please explain? Have you identified other benefits and costs not mentioned above associated to the proposed approach (Option 2)?

While we don't propose an unlimited maximum number of years (option 1), we propose a sliding scale: for the first 10 years, 70% of profits are available for compensation, but for years 11 to 20 only 50% of the CCPs profits would be available for compensation.

This proposal is a variation of option 2 and has roughly the same costs and benefits.

Q10 : If you prefer a different approach, how would it impact this section on the cost and benefit assessment? Please provide details

See under question 9, we propose a sliding scale: for the first 10 years, 70% of profits are available for compensation, but for years 11 to 20 only 50% of the CCPs profits would be available for compensation.

This proposal is a variation of option 2 and has roughly the same costs and benefits.

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.

Our mission: To support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.