

Deutsche Börse Group Response

**to the HMT consultation
on the
Expanded Resolution Regime for Central Counterparties**

Frankfurt, 28 May 2021

A. Introductory comments

Deutsche Börse Group (DBG) provides central clearing services for cash, energy, commodity and derivatives markets both for listed as well as certain over-the-counter (OTC) financial instruments through its EMIR-authorized CCPs Eurex Clearing and European Commodity Clearing (ECC).

DBG appreciates the HMT's ambitions to introduce a UK CCP resolution regime complementing the existing UK regime under the Financial Services Act in accordance with the international standards for CCP resolution by the FSB and CPMI-IOSCO. We therefore welcome the opportunity to provide feedback to the HMT consultation on the "Expanded Resolution Regime for Central Counterparties". Please note that we are providing the following remarks not as an entity that will be directly affected by the new UK regime but from the perspective of an interested market infrastructure provider who has closely followed and supported the international guidance on CCP resolution and the recently introduced EU framework for CCP recovery and resolution.

B. Questionnaire

I) Do you agree with the proposed scope and counterfactual of the NCWO safeguard and counterfactual?

The NCWO principle is generally a fair principle to follow, and it is a positive addition to the existing rules. DBG believes that the NCWO safeguard should be broad enough to balance the flexibility of the resolution authority to act in resolution and the protection of Clearing Members (CMs). It should therefore include the sum of the CCP rulebook, the insolvency proceedings and replacement costs.

DBG hence disagrees with the proposal of excluding the cost of entering replacement transactions from the NCWO counterfactual. The essence of a CCP is to maintain the existence of the transactions between the various participants at the largest possible extent, and to mutualize excessive losses generated by these contracts. Excluding the costs related to the termination of these transactions and the subsequent market turmoil generates challenges to the purpose of CCPs. These costs can be also expected to be particularly substantial and excluding those would expose the authorities to compensation from the tax-payers or other stakeholders unduly.

While DBG recognizes that it is challenging to determine the precise cost of replacing transactions in all specific circumstances and for all financial products, there exist simple metrics that allow for a general estimate of the expected costs, as for example the Initial Margin Requirement (IMR). IMR is precisely the measurement of the cost of replacement of a portfolio within the Margin Period of Risk (liquidation period) with 99% confidence level (which is optimistic in a market event that led to the CCP into resolution). IMR is calculated continuously (or at least daily) by all CCPs under strict regulatory standards and is one of their key expertise as it is a core function of the CCP.

II) What factors should be taken into account when calculating the quantum and position in the default waterfall of the second tranche of SITG?

The second tranche of SITG (SSITG) serves a similar purpose as the existing SITG, which is the incentive for a CCP management and shareholders to invest in, and perform, prudent risk management. As such, the SSITG should be based on the same metrics as the SITG. We therefore agree with the suggestion in point A.52 of the consultation paper that the CCP's minimum capital requirement is generally a good indication of the risk the CCP is facing as a corporation and is, therefore, an appropriate benchmark for calculating the quantum of the SSITG.

More generally, CCP capital/(S)SITG requirements should always be based on metrics proportionate to other management/shareholder incentives (be it revenue, capital, profit etc.), and it should be avoided to compare the CCP requirement to the measurement of the risk brought in the CCP by the CMs. CCPs have little influence on the risk CMs bring into the system, but have flexibility with regards to how they measure it, since they come up with the initial margin calculation methodology. Linking CCPs' liabilities and capital costs to the risk of the CMs, would incentivize aggressive risk management, which is the opposite of the SSITG intended goal.

In addition, as the HMT's outline of the UK CC RR appears to be very similar to the requirements recently introduced by the EU regime, the UK authorities might want to consider ensuring a level playing field also in relation to the calculation and maintenance of the SSITG. In this context, the EU CCP RR foresees that the amount of second SITG shall be within a range of 10% and 25% of the CCP's risk based capital and takes into account a number of criteria for its calibration, such as the structure and internal organization of the CCP and the nature, scope and complexity of their activities; the structure of incentives of the shareholders, management and CMs of CCPs and of the clients of CMs; the rules applying to and the practices of third-country CCPs, etc.

As far as the position of SSITG in the Default Waterfall is concerned, we would agree with the suggestion in point A.50 in the consultation paper that it should be placed prior to the recovery cash calls, and after (part of) the pre-funded Default Fund Contributions (DFCs) of the non-defaulted CMs. CCPs have different manners to address product diversity, with different degree and methods of segregation or segmentation of the default fund. There should be some flexibility for the CCPs to assign the SSITG to different product groups, in a way that follows the existing waterfall design, in order to ensure that the incentive system is aligned among all stakeholders within one CCP.

III) Do you agree with the proposal to limit the statutory VMGH power to default loss scenarios, and instead have a larger cap on the cash call for non-default loss scenarios?

DBG agrees with the proposal of limiting the statutory VMGH power to default loss scenarios, giving to the resolution authority the power of using the VMGH subject to the NCWO counterfactual. We also agree with having instead a larger cap on the cash call for non-default losses in resolution. The larger cap of resolution cash calls should, however, not be used to reduce the recovery cash calls introduced by the CCP in its rulebook.

IV) Do you agree with the proposed power to delay the use of resolution tools for up to 18 months and its current scope?

The preservation of financial stability is one of the most important objectives of resolution. Given the uncertain nature of a resolution, the application of certain resolution tools during or directly after resolution could negatively impact financial stability. Delaying the application of the resolution tools could be more effective and have less adverse effects on the financial system. Having the power to delay the use of resolution tools for up to 18 months can therefore actually benefit the objectives of resolution.

V) Do you agree with the modalities of the proposed compensation process?

While DBG believes that compensation for losses as required by the FSB guidance is a fair principle, we would like to emphasize that we do not support any compensation beyond the NCWO principle. We believe that compensation should not undermine one of the main objectives of resolution, i.e. protection of public funds.

The consultation paper outlines in point A.97 that compensation would also be possible for losses that go beyond the CCP's rulebook and in cases where CMs would not be economically worse off than under the NCWO counterfactual. We are concerned that the decoupling of compensation from the NCWO principle will harm the incentive structure and might expose the authorities to unlimited claims.

Although the usage of tax-payers' money cannot be excluded in a resolution scenario, the reliance on public funds can be minimized by including in the NCWO calculation the direct replacement costs. Please refer to our response under B.I for more information on the inclusion of direct replacement costs. In addition, it should be able for the authorities to recoup public funds being used as a last resort tool in order to safeguard the CCP's incentive structure and loss mutualization function.

VI) What lead in time would be appropriate for the industry to prepare for the new regime? Are there any elements of the new regime that would not require a lead in time?

In order for CCPs, CMs and potentially clients to prepare for the new regime and the changes required in the rulebook/contracts, an implementation timeline of 18 months would seem appropriate. This period is foreseen in the EU CCP RR regime – as the requirements outlined in the consultation paper appear to be very similar to the EU regime, a similar implementation period might be appropriate. Thus, for the SSITG also a longer period (24 months after entry into force of the new regime) could be considered as this would allow CCPs more time to explore options to finance and implement this new requirement following the specification of the SSTIG calibration by the Bank of England.

VII) Do you have any other thoughts on the proposals that you would like to bring to our attention?

The introduction of PTU is welcomed but may not be appropriate for all asset classes equally. OTC swaps for instance, as being unstandardized, require the tear-up of significant market share to be effective without endangering market stability. It may be considered whether other tools could be used to impose a forced match book (assignment of risk for instance).

We hope that you have found these comments useful and remain at your disposal for further discussion.