

# Reading between the lines of the EU's upcoming recovery and resolution framework for CCPs

<b>List of abbreviations</b>	<b>3</b>
<b>Introduction</b>	<b>4</b>
<b>Overview of the EU-wide recovery and resolution framework for CCPs</b>	<b>5</b>
<b>Key implications and impact on the Swiss financial market</b>	<b>6</b>
Prevention and preparation	6
Assumptions for stress scenarios	6
Non-default events	6
CCP rulebooks	8
Recovery measures	8
Variation margin gains haircutting (VMGH)	9
Auctioning	9
Restriction of remuneration	10
Resolution tools	10
Disclosure and transparency	10
<b>How can PwC support you?</b>	<b>11</b>
<b>Contacts</b>	<b>12</b>

# List of abbreviations

BAU:	Business as usual
BIS:	Bank for International Settlement
BRRD:	Bank Recovery and Resolution Directive
CPMI:	Committee on Payments and Markets Infrastructures (within the BIS)
CCP:	Central Counterparty
CRD IV:	Capital Requirements Directive (2013/36/EU)
DFC:	Default Fund Contribution
EBA:	European Banking Authority
EMIR:	European Market Infrastructure Regulation
ESMA:	European Securities and Markets Authority
FMIA:	(Swiss) Financial Market Infrastructure Act
FMIO:	(Swiss) Financial Market Infrastructure Ordinance
FINMA:	(Swiss) Financial Market Supervisory Authority
IM:	Initial Margin
IOSCO:	International Organization of Securities Commissions
NBO:	(Swiss) National Bank Ordinance
PFMI:	Principles for Financial Market Infrastructures (issued by the CPMI-IOSCO)
(P)TU:	(Partial) Tear-up
SI-FMI:	Significant Financial Market Infrastructures
SITG:	Skin in the game
VMGH:	Variation margin gains haircutting
WDC:	Write-down and conversion

# Introduction

With its recent political agreement<sup>1</sup> between the Presidency of the Council of the EU and the European Parliament on a common set of rules for central counterparties (CCPs) and their authorities to prepare for and deal with financial difficulties, the EU is stepping up its rules to make CCPs safer and address systemic risk that could arise from their potential failure<sup>2</sup>.

The proposed rules are aimed at providing national authorities with adequate tools to manage crises and handle situations involving failures of key financial market infrastructures and, as soon as they become EU law, they represent an EU-wide recovery and resolution framework for CCPs. They build on the same principles as the recovery and resolution framework that applies to banks (BRRD)<sup>3</sup>. But unlike the BRRD, the new framework will be endorsed as a regulation, which provides for uniform prudential requirements applicable to CCPs, as a directive could create inconsistencies by the adoption of potentially different national laws. At present, there are no harmonised EU rules for the unlikely situations in which CCPs would face severe distress or failure.

Following the finalisation of technical work, the text of the proposed regulation will then be processed through the EU legislative process in order to be soon adopted by the EU Parliament and Council.

Even though it isn't bound by the new EU-wide recovery and resolution framework for CCPs, Switzerland has also adopted legislation addressing issues dealt within the proposed rules. Largely following the international standards set out in the CPMI-IOSCO's Principles for Financial Market Infrastructures (PFMIs)<sup>4</sup>, the Financial Market Infrastructure Act (FMIA) and the Financial Market Infrastructure Ordinance (FMIO<sup>5</sup>) both in effect since 1 January 2016, brought the Swiss regulations on financial market infrastructures and derivatives trading into line with international standards. Since then a number of amendments<sup>6</sup> have been made to the FMIO in the light of international developments.

In addition, the FMIO requires<sup>7</sup> explicitly that the recovery and resolution plan of significant financial market infrastructures (SI-FMIs) must consider the regulations of foreign supervisory authorities. Practical experience has also shown that FINMA assesses and eventually approves those plans also in line with international regulations, and in cases where the Swiss regulation is not explicit enough, recourse is or can be taken to international<sup>8</sup> and the European regulation.

With certain limited exceptions, the new EU framework will start to apply 18 months after the date of entry into force of the regulation to allow time to adopt all implementing measures and for market participants to take the necessary steps to comply with the new rules. This means that, assuming an early second reading agreement<sup>9</sup> and a subsequent swift adoption process, the new rules cannot come into force until the beginning of the year 2023 at the earliest.

But, the recently agreed common set of rules will bring greater detail and clarity to the prevailing uncertainty around the interpretation of existing rules regarding the recovery and resolution of CCPs. This means it's worthwhile taking a closer look at the new EU framework as it will provide greater certainty to market participants, particularly in times of stress as well as during a pandemic (as COVID-19 exerts additional pressure on already strained capital and funding).

Viewed in this context, the paper aims to present a brief rundown of the new EU framework and reflect on its implications for the Swiss financial market, its CCP (i.e. SIX x-clear), their clearing members as well as their clients.

<sup>1</sup> Council of the EU press release 420/20, 23/06/2020, Clearing houses: Presidency and Parliament reach political agreement on recovery and resolution (available under: <https://www.consilium.europa.eu/en/press/press-releases/2020/06/23/clearing-houses-presidency-and-parliament-reach-political-agreement-on-recovery-and-resolution/pdf>).

<sup>2</sup> Given their growing importance in financial markets, the failure of a CCP could affect banks and the wider economy, as they manage significant amounts of counterparty risk and link multiple banks, other financial counterparties and corporates.

<sup>3</sup> The bank recovery and resolution directive (BRRD) was adopted in spring 2014.

<sup>4</sup> The Financial Stability Board (FSB) and the Committee on Payment and Market Infrastructures and the International Organization of Securities Commissions (CPMI-IOSCO) agreed on global standards to guarantee central counterparty resilience, recovery planning and resolvability in 2014.

<sup>5</sup> Together with the corresponding FINMA Financial Market Infrastructure Ordinance (FMIO-FINMA).

<sup>6</sup> See FMIA fact sheet from the FDF (available under: <https://www.efd.admin.ch/efd/en/home/themen/wirtschaft--waehrung--waehrung--finanzplatz/finanzmarktpolitik/financial-market-infrastructure-act--fmia--fb-finanzmarktinfrastrukturgesetz.html>).

<sup>7</sup> In its art. 20 (1).

<sup>8</sup> The Guidance on Central Counterparty Resolution and Resolution Planning already serves as guidance for CCP Resolution and Resolution planning by setting out powers for resolution authorities to maintain the continuity of critical CCP functions (available under: <https://www.fsb.org/wp-content/uploads/P050717-1.pdf>); Basel Committee on Banking.

<sup>9</sup> See p. 38 of the Handbook on the ordinary legislative procedure of the European Parliament (available under: <http://www.epgencms.europarl.europa.eu/cmsdata/upload/10fc26a9-7f3e-4d8a-a46d-51bdadc9661c/handbook-olp-en.pdf>).

# Overview of the EU-wide recovery and resolution framework for CCPs

The future EU-wide recovery and resolution framework for CCPs is a comprehensive framework considering the global and systemic nature of CCPs. The recovery and resolution will be based on a three-step approach:

**Figure 1:** Three-step approach as taken from the Council of the EU, PRESS RELEASE 420/20, 23. June 2020

1	<ul style="list-style-type: none"><li>• <b>Prevention and preparation:</b> CCPs and resolution authorities will be required to draw up recovery and resolution plans on how to handle any form of financial distress which would exceed CCPs existing resources. If resolution authorities identify obstacles to resolvability in the course of the planning process, they can require a CCP to take appropriate measures.</li></ul>
2	<ul style="list-style-type: none"><li>• CCPs can take <b>recovery measures</b>, according to certain viability indicators and based on the prepared recovery plan. These include cash calls to non-defaulting clearing members, the reduction in value of the collateral provided daily to the CCP (so-called variation margin gains haircutting), and the use of the CCP's own resources.</li><li>• Furthermore, supervisory authorities will have the possibility to <b>intervene at an early stage</b>, i.e. before the problems become critical and the financial situation deteriorates irreparably. For example, they will be able to require the CCP to undertake specific actions in its recovery plan or to make changes to its business strategy or legal or operational structure.</li></ul>
3	<ul style="list-style-type: none"><li>• Finally, in the unlikely case of a CCP failure, national authorities will have the possibility to resort to <b>resolution tools</b>. These include the (partial) termination of the CCP's contracts, variation margin gains haircutting, the write-down of CCP capital, a cash-call to clearing members, the sale of the CCP or parts of its business or the creation of a bridge CCP.</li><li>• While in certain limited cases, extraordinary public support may be provided as a last resort, the purpose of resolution actions is to minimise the extent to which the cost of a CCP's failure is borne by taxpayers, while making sure that shareholders bear an appropriate part of the losses and that taxpayer funds are recouped to the maximum possible extent.</li></ul>



# Key implications and impact on the Swiss financial market

In the following, we've selected a set of rules for which we believe special attention is particularly warranted for CCPs, clearing members and their clients, as they touch upon clearing members and their client's exposure and liabilities to the CCP as well as the CCP's own resources.

Our assessment on the key implications and impact on the Swiss financial market is summarised below and organised along the three steps described above: prevention and preparation, recovery measures and resolution tools.

## Prevention and preparation

One of the main objectives of the new EU-wide recovery and resolution framework is to reduce the probability of CCP failure by introducing effective incentives for CCPs, clearing members and their clients not to let the situation deteriorate further and to incentivise cooperative behaviour. This should be guaranteed through the recovery plans.

For this purpose, a minimum standard will be established with regard to the contents and information to be included in recovery plans to make sure that at least all CCPs in the EU have sufficiently detailed plans for recovery should they face financial distress. Switzerland has also already enacted legislative changes that require CCPs to draw up recovery plans and introduce mechanisms to resolve failing CCPs<sup>10</sup>. But, the relevant Swiss regulation is not sufficiently explicit in several places and does not contain concrete guidelines on the content of recovery plans. As a result, in practice, additional international regulations are consulted (e.g. CPMI-IOSCOs Recovery Guidance<sup>11</sup>).

In contrast, the newly introduced minimum standard with regard to the contents and information to be included in recovery plans will provide more clarity, which could also affect Swiss CCP (i.e. SIX x-clear) recovery plans, in particular with regard to:

- **Assumptions for stress scenarios**

Extreme market stress events are likely to affect multiple clearing members. Therefore, to cover potential default risks effectively, a CCP should size its default fund<sup>12</sup> properly in order to anticipate a default of several clearing members.

The relevant Swiss legislation<sup>13</sup> already provides for such a case, but the requirement "only" provides for a default of the two participants or two groups of participants which would generate the largest aggregate payment obligation for the CCP (so called Cover 2 scenario). But, it can be assumed that FINMA would use its discretionary powers to impose stricter requirements on its CCP (SIX x-clear) which goes slightly<sup>14</sup> beyond a Cover 2 scenario if it deems necessary.

The new EU-wide recovery and resolution framework, however, introduces an even stricter rule, as it provides for recovery plans to consider an appropriate range of scenarios – which, among others, contemplate situations of stress that would be more extreme than those used for the purposes of regular stress testing during BAU<sup>15</sup>, while remaining plausible, like the failure of more than two clearing members to which the CCP has the largest exposure and one or several other CCPs.

As the new EU framework goes far beyond a Cover 2 scenario, FINMA could use this as an opportunity to also demand more severe stress assumptions from its supervised CCP. In doing so, it could require it to re-size its pre-funded default fund resources to meet a scenario beyond the default of the largest two clearing members and of other CCPs. This in turn would prompt the CCP to impose potentially additional/heightened margin requirements on its clearing members and their clients, requiring them to provide more liquidity and/or additional collateral in future.

- **Non-default events**

A clearing member default is not the only source of risk faced by a CCP and its clearing members and their clients. CCPs are responsible for managing substantial amounts of collateral daily and as a result they are vulnerable to cyber-threats and attacks that could lead to significant monetary loss that may not be recoverable. CCPs could also incur losses resulting from operational failures, fraud, theft or malicious acts of employees or external actors, credit deterioration of investments and custodian or settlement bank failure. Clearing members and their clients usually don't want to bear losses which occur during a non-default event, since they aren't responsible for the choices that led to them.

<sup>10</sup> See section 1. Introduction

<sup>11</sup> CPMI-IOSCO Recovery of financial market infrastructures, October 2014 (revised July 2017).

<sup>12</sup> The default fund is sized as the amount of uncollateralised stress loss that a CCP determines it would incur in an extreme but plausible scenario.

<sup>13</sup> See art. 28b (3) and 29 (3) lit. b NBO.

<sup>14</sup> For example, by including a simultaneous default of one and/or several small or mid-sized clearing members to a Cover 2 scenario.

<sup>15</sup> According to Chapter XII of Commission Delegated Regulation (EU) No 153/2013 (EMIR). Whereas the European Securities and Markets Authority (ESMA), in accordance with EMIR, initiates and coordinates Union-wide assessments of the resilience of CCPs to adverse market developments using also Cover 2 scenarios.

**Figure 2: Distinction between a default event and a non-default event**

Default-Event	Non-Default-Event
A scenario in which one or more clearing members fail to honour their financial obligations to the CCP	A scenario in which losses are incurred by a CCP for any reason other than a default of a clearing member, such as business, custody, investment, legal or operational failures or fraud, including failures resulting from cyber-attacks, or uncovered liquidity shortfalls

As a result, the new EU framework introduces the general principle that losses should be distributed between CCPs, clearing members and their clients as a function of their ability to control the risks. This is in order to create sound incentives ex-ante and to guarantee a fair allocation of losses. And on that basis, loss allocation also for non-default losses should be proportional to the level of responsibility of each stakeholder involved.

In this respect, it clarifies that recovery plans should make sure that the CCP's capital is relied upon to bear first losses in default cases and even more so in non-default cases. Pre-funded CCP capital, also known as "skin in the game" (SITG), within the loss allocation is the principle mechanism to align a CCP's incentives and guarantees effective risk management related to the CCP's clearing activities.

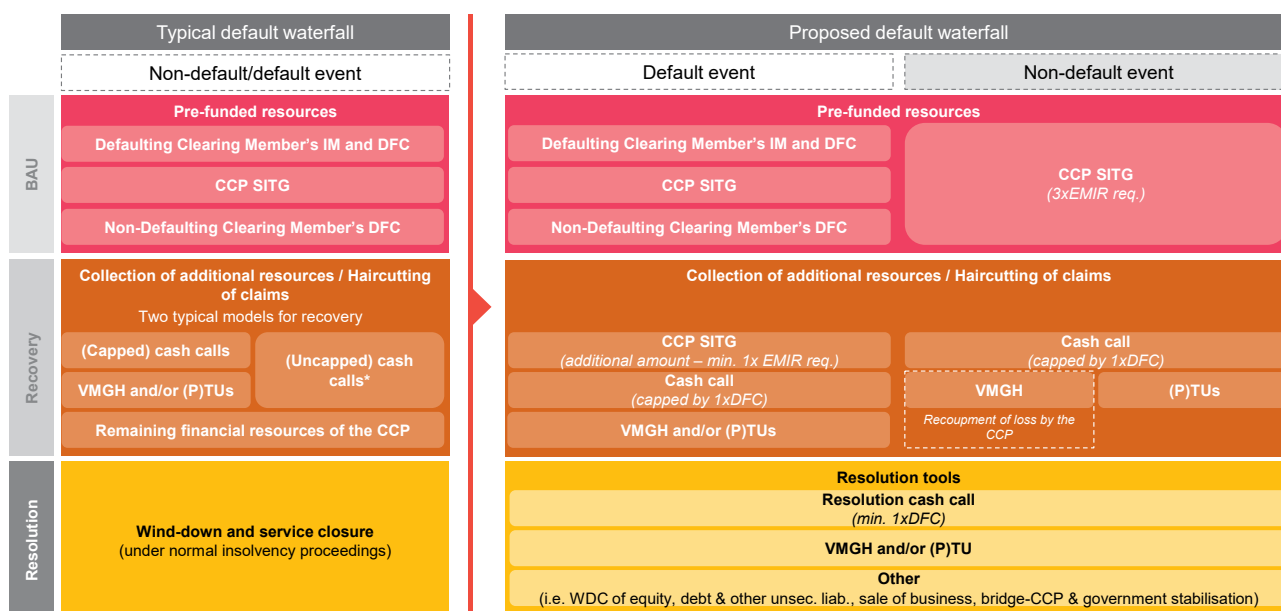
Compared to the relevant existing international standards<sup>16</sup> which provide for general business risks<sup>17</sup>,

i.e. risks where losses occur which are not caused by a participant default and the relevant Swiss regulation, the new EU framework further reinforces that CCPs bear responsibility for non-default losses and imposes concrete capital requirements on the CCP which must be set aside by the CCP against those non-default losses. In addition, it defines a dedicated loss allocation mechanism explicitly for non-default events, where CCPs are not to use the default fund and the default waterfall.

This means following a non-default event, a CCP is to use dedicated own resources equivalent to 3x the minimum SITG required by EMIR<sup>18</sup> prior to the use of pre-defined (i.e. capped) cash assessments<sup>19</sup> from non-default clearing members and/or position and loss allocation tools (i.e. VMGH and/or (PTUs).

The following graph shows the default waterfall for default events and non-default events as proposed by the new EU framework:

**Figure 3: Loss allocation as proposed by the new default waterfall**



\* Many CCPs, incl. those with uncapped cash assessment rights, also have powers to reduce their liabilities because of the performance risk associated with cash calls (i.e. the risk that a participant may be unwilling or unable to meet a call).

<sup>16</sup> CPMI-IOSCO's guidance for the recovery of financial market infrastructures, October 2014 (revised July 2017).

<sup>17</sup> See PFMI paragraph 3.15.1 for the definition and further discussion of general business risk.

<sup>18</sup> Article 45(4) of Regulation (EU) 648/2012 (EMIR).

<sup>19</sup> Pre-defined cash assessment from non-defaulting clearing members providing them to make a minimum contribution in cash to the CCP up to an amount equivalent to their contribution to the CCP's default fund (1xDFC).



In case of a default event, the new EU framework also provides for an additional layer of SITG equivalent to the amount of 1x of the minimum SITG required by EMIR prior to the use of the capped cash assessments from non-default clearing members and/or position and loss allocation tools.

If FINMA were to adopt similar but the Swiss version of these specific EU rules, this would lead to a significant increase in the minimum capital requirements (i.e. SITG) for the Swiss CCP (i.e. SIX x-clear). And it would most likely require the development of appropriate ex-ante arrangements with existing owners to raise additional equity capital, in order to make sure that SIX x-clear can continue to perform its obligations.

Moreover, linking additional cash assessments to participants' past contribution to the default waterfall (i.e. 1x DFC), will enable them to actively manage their exposure to the CCP, as usually default contributions proxy the risk brought by participants to the CCP. The capped cash assessments would therefore provide ex-ante incentives for clearing members and their clients to limit the risk that they bring to the CCP, and as a result make sure that potential additional cash assessments in a non-default or default event do not lead to systemic risk or a liquidity crunch.

- **CCP rulebooks**

Appropriate incentive structures for the CCP's owners, clearing members and their clients for cooperative behaviour and for controlling the amount of risk that they bring to or incur in the system must be credible. As such they must be included in the CCPs operating rules.

The recovery plan should therefore explicitly form part of the operating rules of the CCP agreed contractually with clearing members pursuant to the new EU framework. Those operating rules should further contain provisions to guarantee the enforceability of recovery measures outlined in the plan in all scenarios. In addition, in view of the global nature of the markets served by CCPs, the EU framework also requires guaranteeing the ability of a CCP to apply the recovery options, where necessary, to contracts or assets governed by the law of a third country (as Switzerland) or to entities based in third countries. As a result, the CCP's operating rules should include contractual provisions guaranteeing this ability.

Whereas, during a resolution scenario, the operating rules of a CCP should contain provisions to guarantee the enforceability of resolution measures by resolution authorities. These provisions may also affect the Swiss market participants, as foreign resolution authorities have the powers to apply a partial or full termination of contracts (i.e. a (P)TU) to them for example, and can also require an additional cash assessment (so-called resolution cash call<sup>20</sup>). In this case, CCP operating rules should include the amount of the resolution cash call of minimum 1x DFC.

In addition, the foreign resolution authority can also require the CCP to make changes to its operating rules (including in relation to its terms of participation) and

other contractual arrangements in order to remove any impediments to resolvability. Prior to taking any resolution measures, it can also consider enforcing any contractual obligations by clearing members to meet cash calls or to take on positions of defaulting clearing members, whether through an auction or other agreed means.

The negotiation between a CCP its owners, clearing members and their clients in order to agree to allocate losses and liquidity shortfalls and replenish financial resources by a set of certain means, has so far been preceded by difficult negotiations, as the international regulations were vastly principle based and therefore gave a lot of room for interpretation. In contrast, the new EU framework gives greater clarity and detail regarding what must be contractually agreed between the CCP and its clearing members and their clients.

In this context, Swiss clearing members and their clients should expect their contractual arrangements with their CCP to be adjusted accordingly, allowing them to use the information provided by the new EU framework to understand how the CCP would respond in a recovery and/or a resolution procedure, further allowing them to more predictably manage their exposure with their CCP. It should also be noted that clearing members and their clients should align their FMI contingency plans accordingly in order to make sure that the covered ex-ante arrangements therein provide for the updated rulebooks.

### Recovery measures

The appropriateness of a given recovery tool or set of tools usually vary based on particular CCPs and their individual circumstances. For this purpose, the CPMI-IOSCO recovery guidance provides for a certain set of characteristics to support a CCP to evaluate the strengths and weaknesses of tools, so that it can choose the most appropriate set for each relevant recovery scenario, including the sequence in which they should use it.

Current practice shows that, despite the additional guidance on a menu of tools, the selection of an appropriate set of recovery tools often leads to intensive discussions with regulators, as they may find that they do not sufficiently meet the characteristics set out in this guidance, and also with clearing members and their clients, as they may feel they are disproportionately affected by the selected recovery tools.

So, in following the above-mentioned general principle, the EU framework provides for the sequencing of the use of recovery tools in order to balance the allocation of losses between CCPs, clearing members and their clients. This is to prevent them from (disproportionately) affecting the clients of the clearing members and so that substantial loss absorption by clearing members should be foreseen before any tools are used that allocate losses to their clients.

In our view, the EU framework provides more clarity and detail in order to facilitate the implementation of certain tools to make them more effective and to establish a more transparent loss allocation in times of recovery.

<sup>20</sup> See section "Resolution tools" for further details.



This applies in particular to the following specific recovery tools:

### Variation margin gains haircutting (VMGH)

This measure, although deemed to be a powerful tool<sup>21</sup> is not easy to implement as it usually carries potentially severe drawbacks and risks for clearing members and their clients and eventually can undermine their confidence in the CCP.

When haircutting variation margin, the CCP reduces the value of any gains it should have paid to non-defaulting members and their clients. Losses are allocated only to clearing members and their clients who have experienced a gain, as a result concentrating the loss on a subset of them. It isn't necessarily guaranteed that the losses are allocated to those who are best able to cope with them, because the positive position of a clearing member or its client within a particular CCP may not be a perfect indicator of its relative ability to absorb a credit loss or liquidity shortfall.

For example, the clearing member or its client might have an equal (or larger) opposite position outside the CCP that it is hedging. In addition, depending on the contracts between (direct) clearing members and their (indirect) clients, indirect participants may be exposed to losses if the variation margin on their positions is haircut by the CCP. What's more, the burden of variation margin haircutting may fall more heavily on those with directional positions who may tend to be end users, than on those with balanced positions.

In exposing clearing members and their clients to undesirable liquidity risk this recovery tool is argued to be impossible to implement in practice today. In order to incentivise clearing members and their clients to support the CCP in its recovery efforts, the EU framework introduces a loss compensation mechanism in exchange for allocated losses to them through VMGH, which go beyond the default waterfall in a non-default event once a matched book has been restored.

As a result, CCP's are required to provide compensation to the participants<sup>22</sup> for their loss, either through cash payments or, where appropriate, through pre-defined instruments of ownership in future profits of the CCP. Such instruments should be equity-like to make sure that they would not render the CCP insolvent during the recovery process and should place the claims of participants who contributed to the recovery of the CCP ahead of the claims of CCP shareholders.

### Auctioning

The viability of a CCP depends primarily on its ability to manage clearing members' defaults effectively by successfully transferring a defaulter's portfolio to a solvent clearing member or another participant in order to re-establish a matched book. To deal with a defaulter's

outstanding obligations, a CCP would usually seek to sell, through an auction for example, any outstanding positions to direct, indirect participants or third parties.

But, the implementation of this tool affects the CCP and its clearing members and their clients in several ways:

- Firstly, a CCP would need to meet the costs and to cover any losses arising from this process by drawing on available default resources and loss-sharing arrangements, in accordance with the CCP's default waterfall and recovery plan to fund an auction.
- Secondly, in determining who can participate in such a sale, a CCP is expected to consider the fact that successful bidders are acquiring an exposure to the CCP and will be required to meet ongoing risk management and other obligations under the CCP's operating rules.

As a result, the use of such a tool needs appropriate ex-ante incentives for non-defaulting participants to support and to participate in any auction. The EU framework provides explicitly for arrangements and measures incentivising non-defaulting clearing members to bid competitively in auctions of a defaulted member's positions to be included in the recovery plan, which substantiates the legal basis of this tool, making it more effective.

Additionally, as part of the early intervention measures, the regulator may in future require the CCP to replenish its financial resources in a timely manner. The EU framework allows – exceptionally and on a one-off basis – clients of clearing members to participate directly in auctions, while waiving prudential requirements<sup>23</sup> for these clients, which they would normally have to meet, as taking positions from defaulting clearing members would also increase their exposure to the CCP.

Additionally, in order to facilitate a re-established matched book, the EU framework allows the resolution authority during a resolution to apply the VMGH or a dedicated resolution cash call on clearing members and their clients, in order to provide the CCP with funds to meet an auction bid which enables the CCP to allocate the defaulter's positions.

Current practice shows that by including this measure in recovery plans it turns out that it is only applied to a subset of participants and the participation is voluntary, making this measure insufficiently well developed and reliable in this form. Providing more tangible incentives as mentioned above as well as the requirement that it is based on contractual arrangements laid out in the operating rules of the CCP, this measure could in future also represent a credible and reliable tool for Swiss market participants in a potential recovery situation of SIX x-clear.

Clearing members offering indirect access to the CCP should also be prepared to have up-to date information on positions on client omnibus and segregated accounts to make sure that affected client positions can be transferred smoothly.

<sup>21</sup> See recital 4.2.15 of CPMI-IOSCO's recovery guidance.

<sup>22</sup> Clearing members can pass on losses to their clients (via contractual arrangements) but clients are also eligible for compensation, and predefined instruments provide certainty about compensation.

<sup>23</sup> Pursuant to Chapter 3 of Title IV of Regulation (EU) 648/2012 (EMIR) other than margin requirements as set out in Article 41 of Regulation (EU) 648/2012 (EMIR).

## Restriction of remuneration

Upon activation of the recovery plan and as an early intervention measure (in order to replenish its financial resources), the EU framework allows the regulator to restrict or prohibit any remuneration of equity and instruments treated as equity to the fullest extent possible without triggering outright default, including dividend payments and buybacks by the CCP, and it may also restrict, prohibit or freeze any payments of variable remuneration<sup>24</sup> of discretionary pension benefits or of severance packages to management.

The exercise of this power will presumably also affect the shareholders, clearing members and their clients in Switzerland, as the EU framework provides for cooperation arrangements with relevant third-country authorities, in particular where a third country CCP (e.g. SIX x-clear) provides services or has subsidiaries in one or more EU member states (e.g. BME in Spain). Those cooperation arrangements also include the right to exercise this power to them and establish a strong incentive for shareholders to monitor the health of its CCP during normal circumstances.

## Resolution tools

The resolution tools introduced with the new EU framework include an additional<sup>25</sup> resolution cash call to clearing members and their clients specifically earmarked for the resolution authority in the CCP operating rules.

As a result, the resolution authority can require non-defaulting clearing members to make contributions in cash to the CCP. The resolution authority also has the power to exercise the resolution cash call regardless of whether all contractual obligations requiring cash contributions from non-defaulting clearing members have been exhausted. In addition, if a non-defaulting clearing member doesn't pay the required amount, the resolution authority can require the CCP to place that clearing member in default and use the clearing member's initial margin and default fund contribution.

So, it allows the resolution authority to use a portion of the cash margin of non-defaulting participants as a mutualised resource to cover CCP losses, at a minimum with an amount equivalent to the clearing member's contribution to the default fund (1xDFC), but eventually depending on the second valuation which is needed to inform the decision of the resolution authority on the extent and necessity of a resolution cash call.

Although this resolution tool has no legal basis in Switzerland, FINMA may also apply it in subsequent international regulations. The Swiss CCP (i.e. SIX x-clear), the clearing members and their clients should be aware of this and should expect an update of their rulebooks in future. They should also adjust their risk methodology accordingly in order to manage and monitor their exposure to their CCP.

## Disclosure and transparency

The new EU framework also provides for regular stress testing and crisis simulation exercises with respect to potential system-wide stress events, performed by the relevant EU supervisory authority<sup>26</sup>. The aim is to assess CCP recovery and resolution arrangements across the EU in terms of their aggregate effect on EU financial stability and to incentivise the CCP to put specific formal mechanisms into place holding them accountable for the timeliness and accuracy of their rulebooks.

As a CCP's activity spans multiple jurisdictions, this would probably also affect the Swiss CCP (i.e. SIX x-clear), the clearing members and their clients. Since, also with regard to the required cooperation with third-country regulators, FINMA would probably work with corresponding EU regulators to test playbooks and simulate resolution and default scenarios, for example, through crisis management groups in order to give the regulators further insight into the CCP's preparations for a crisis scenario.

As a result, the Swiss CCP (i.e. SIX x-clear) also needs to enhance its disclosures with supporting material to FINMA and probably to its clearing members and their clients regarding its risk methodologies, back testing, stress testing and clearing members as well as their client's loss allocation.

<sup>24</sup> Under Directive 2013/36/EU (CRD IV) and EBA Guidelines on Remuneration Policies EBA/GL/2015/22.

<sup>25</sup> Additional to prefunded resources, based on statutory powers available to a resolution authority in accordance with Article 31 of the new EU framework and as laid out in the operating rules of the CCP.

<sup>26</sup> ESMA (European Securities and Markets Authority).

# How can PwC support you?

- Supporting the further development and the regular and timely update of the recovery plan as well as the operational continuity planning of the CCP and/or their clearing members, making sure that the critical functions can be maintained in compliance with regulatory requirements.
- Supporting the development of operational playbooks as, for example, the FMI contingency plan outlining measures to guarantee access to payment, clearing, settlement and custody services ahead of and during resolution of a clearing member.
- Help in further developing any preparatory measures and playbook activities laying out the operational steps required in a crisis to support the recovery (including wind-down) plan.
- Supporting the process to design and execute testing of the established documentation (i.e. recovery plan) either internally with board members or externally with regulators during their crisis simulation exercises or stress testing.
- Assistance with responding to special requests (e.g. input for resolution plan) from FINMA/SNB as well as senior management.
- Supporting banks, insurers and financial market infrastructures with analyses on the impact of new Swiss and international regulatory developments on recovery and resolution planning.



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