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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

**on the treatment of central counterparty equity in the write-down and conversion tool
under Regulation (EU) 2021/23**

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1. Introduction

The fourth subparagraph of Article 96 of Regulation (EU) 2021/23 on a framework for the recovery and resolution of central counterparties¹ (CCP-RRR) mandates the Commission to report by 31 December 2021 to the European Parliament and the Council on the application of Article 27(7) of the CCP-RRR. The Commission is asked to assess whether there is a need for any further amendments with regard to the application of the write-down and conversion tool in the event of resolution of central counterparty (CCPs) in combination with other resolution tools that result in financial losses being borne by clearing members. Recent market turmoil has demonstrated that Regulation (EU) No 648/2012 on OTC² derivatives, central counterparties and trade repositories³ (EMIR) has contributed to the increased resilience of CCPs and wider financial markets against the many risks processed and concentrated in CCPs. However, in light of the severe impact on financial stability that a financial distress or a failure of a CCP would have, the CCP-RRR will increase the preparedness of CCPs and public authorities for such extreme scenarios.

This report takes into account the completed and ongoing work of the Financial Stability Board (FSB) and input from Crisis Management Group members of EU CCPs. Positions from industry stakeholders are also considered in the assessment.

2. What are the resolution tools?

The write-down and conversion tool is one of the four resolution tools offered by the CCP-RRR to resolution authorities to ensure that resolution objectives are met. These objectives include:

- ensuring the continuity of the CCP's critical functions and links with other financial market infrastructures;
- avoiding a significant adverse effect on the EU financial system;
- protecting public funds by minimising reliance on extraordinary public financial support and the potential risk of losses for taxpayers.

The other three resolution tools are the position and loss allocation tools, the sale of business tool and the bridge CCP tool.

The position and loss allocation tools can be used to terminate contracts, reduce the value of any gains payable by the CCP to non-defaulting clearing members, and make resolution cash calls. Cash calls require non-defaulting clearing members to make a cash contribution to the CCP.

¹ OJ L 22, 22.1.2021, p. 1.

² Over-the-counter derivatives as defined in Article 2(7) of Regulation (EU) No 648/2012

³ OJ L 201, 27.7.2012, p. 1.

The sale of business tool can be used to transfer instruments of ownership issued by a CCP or any assets, rights obligation or liabilities of the CCP, without the consent of shareholders or any third party to a purchaser.

The bridge CCP tool can be used to transfer instruments of ownership issued by a CCP or any assets, rights obligation or liabilities of the CCP to a bridge CCP, without the consent of shareholders or any third party. A bridge CCP is a legal person controlled by the resolution authority and wholly or partially owned by a public authority.

The write-down and conversion tool can be used to write down and convert instruments of ownership, debt instruments and other unsecured liabilities. Certain liabilities are excluded from the scope of this tool, including those to employees, commercial or trade creditors, other CCPs, central banks, and initial margins.

The write-down leads to the absorption of losses incurred by the CCP, and the conversion then recapitalises the CCP. This ensures that the capital requirements – according to Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) – are met again.

3. What is required under Article 27(7) of the CCP-RRR?

Under Article 27(7) of the CCP-RRR, the resolution authority must write down and convert any instruments of ownership, debt instruments and other unsecured liabilities immediately before or together with the application of another resolution tool. This is not required if a different sequence is applied that would minimise deviations from the ‘no creditor worse off’ (NCWO) principle and better achieve the resolution objectives.

The NCWO principle is a safeguard provided for under Article 60 of the CCP-RRR. It ensures that shareholders, clearing members and other creditors do not incur greater losses in resolution than they would have if the CCP had been wound up under normal insolvency proceedings, following the full application of the applicable contractual obligations and other arrangements in its operating rules (the ‘NCWO counterfactual’). This is achieved thanks to an independent valuation that compares the actual treatment received in resolution with their hypothetical treatment in insolvency. If this valuation shows that creditors had to incur greater losses, they are entitled to a payment of the difference. The European Securities and Markets Authority is currently developing regulatory technical standards to further specify the methodology for carrying out the valuation.

Recital 96 of the CCP-RRR explains that, in a resolution, CCP equity holders should absorb losses first in a way that minimises the risk of legal challenges under the NCWO principle. Referring to ongoing work in the international standard-setting bodies (see in Section 4), the European Parliament and the Council asked the Commission to review how the rules on the write-down of equity are applied following the conclusion of that work.

The scope of this report is therefore the treatment of CCP equity in resolution and its interaction with the NCWO counterfactual. Article 27(7) of the CCP-RRR presumes that CCP equity should absorb losses first and be fully loss absorbing in resolution. However, the order/waterfall for imposing losses is not necessarily in line with the usual creditor hierarchy

in insolvency. The reason is that equity is only exposed to losses up to the amount of the first skin in the game⁴ (Article 45(4) of the EMIR and Article 35 of Commission Delegated Regulation (EU) No 153/2013⁵) and, in future, the second skin in the game (Article 9(14) of the CCP-RRR). All remaining losses are to be allocated to clearing members. This is the case following a default event and, in some CCPs and to a limited extent, a non-default event. In addition, the NCWO counterfactual in the CCP-RRR includes the full application of the contractual obligations and other arrangements in the CCP's operating rules for valuation purposes. Therefore, depending on whether and how equity absorbs losses in a CCP's operating rules and on national insolvency law, this mechanism can lead to a situation where shareholders can claim that they would not have been affected outside resolution. This could in particular be the case if the CCP was put into resolution before the full application of the recovery plan to achieve the resolution objectives.

4. Ongoing international work

Practical experience with resolution planning in the EU remains limited, since the resolution planning rules of the CCP-RRR will only apply from August 2022. However, the Financial Stability Board (FSB) has published guidance documents on this issue (see Section 4(a) below). Private stakeholder and cooperation bodies have also shared their views⁶. These bodies include the European Association of CCP Clearing Houses (EACH), CCP12 (the global association for CCPs) and the International Swaps and Derivatives Association (ISDA).

In addition, limited practical experience has been gained by members of Crisis Management Groups. These are groups set up, in line with feature 8 of the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*⁷, for CCPs that are systemically important in more than one jurisdiction. The Crisis Management Groups are tasked with coordinating resolution planning and resolvability assessments between home and host resolution authorities.

a Work by the FSB

The FSB issued its updated *Key Attributes of Effective Resolution Regimes for Financial Institutions* in October 2014 by expanding it with an annex that specifically deals with financial market infrastructures. In this report, the FSB states that resolution powers should be exercised in a way that respects the hierarchy of claims and equity should absorb losses first in resolution⁸.

⁴ The CCP's dedicated own resources that it must use to absorb losses before using the default fund contributions of non-defaulting clearing members.

⁵ Commission delegated Regulation (EU) No 153/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties, OJ L 52, 23.2.2013, p. 41.

⁶ <https://www.fsb.org/2020/08/public-responses-to-consultation-on-guidance-on-financial-resources-to-support-ccp-resolution-and-on-the-treatment-of-ccp-equity-in-resolution/>

⁷ *Key Attributes of Effective Resolution Regimes for Financial Institutions*, FSB, 2014, [Key Attributes of Effective Resolution Regimes for Financial Institutions \(fsb.org\)](https://www.fsb.org/wp-content/uploads/Key-Attributes-of-Effective-Resolution-Regimes-for-Financial-Institutions.pdf).

⁸ *Key Attributes of Effective Resolution Regimes for Financial Institutions*, FSB, 2014, p. 11.

The FSB published its *Guidance on Central Counterparty Resolution and Resolution Planning* in 2017⁹. In this report, the FSB explains that owner's equity in the CCP should absorb losses in resolution if it has not been written down yet (in line with the CCP's rules and contractual arrangements). For default losses, equity should be fully loss absorbing and it should be clear and transparent at which point it will be written down. For non-default losses, equity should absorb them no later than the point at which all applicable loss allocation arrangements available under the CCP's rules and arrangements for non-default losses have been exhausted. Moreover, equity should be written down before losses are allocated to creditors, in line with the creditor hierarchy under the applicable legislation¹⁰.

The FSB issued its *Guidance on Financial Resources to support CCP Resolution and on the Treatment of CCP Equity in Resolution* in November 2020¹¹. The report clarifies that, depending on the CCP's contractual arrangements and national insolvency law, actions in resolution that expose CCP equity to larger default or non-default losses than in liquidation under the insolvency regime applicable in the jurisdiction could, based on the treatment received under the counterfactual, enable equity holders to raise NCWO claims. This may lead to a result inconsistent with the other *Key Attributes* principle that equity should be fully loss absorbing in resolution. This may also raise moral hazard concerns by allowing equity holders to maintain their equity interest in a CCP after resolution while participants have to bear losses.

Building upon the *Key Attributes* and the guidance mentioned above, the FSB specifies that the resolution authority should assess the impact that any limits on the amount of CCP equity exposed to losses has on its ability to take appropriate action to achieve the expected treatment of CCP equity. At the stage of resolution planning, the resolution authority should understand issues such as the following:

- the treatment of equity under existing recovery arrangements and in the default waterfall;
- the extent to which equity would be exposed to losses in liquidation under the applicable insolvency regime, based on the treatment received under the counterfactual;
- NCWO safeguards, including potential claims by shareholders¹².

Based on this assessment, the resolution authority can identify various options to help ensure equity bears losses during an actual resolution, including:

- changing contractual loss allocation arrangements;
- full or partial write-down of CCP equity;
- transferring critical CCP operations (assets) and certain liabilities to a bridge entity and placing the remnant CCP into liquidation/receivership;

⁹ *Guidance on Central Counterparty Resolution and Resolution Planning*, FSB, 2017, [Guidance on Central Counterparty Resolution and Resolution Planning \(fsb.org\)](https://www.fsb.org/2017/04/guidance-on-central-counterparty-resolution-and-resolution-planning/).

¹⁰ *Guidance on Central Counterparty Resolution and Resolution Planning*, FSB, 2017, p. 9.

¹¹ *Guidance on Financial Resources to Support CCP Resolution and on the Treatment of CCP Equity in Resolution*, FSB, 16 November 2020, [Guidance on Financial Resources to Support CCP Resolution and on the Treatment of CCP Equity in Resolution: Final Report \(fsb.org\)](https://www.fsb.org/2020/11/guidance-on-financial-resources-to-support-ccp-resolution-and-on-the-treatment-of-ccp-equity-in-resolution-final-report/).

¹² *Guidance on Financial Resources to Support CCP Resolution and on the Treatment of CCP Equity in Resolution*, FSB, 2020, pp. 18-19.

- diluting existing ownership by raising new capital through conversion or issuance of new shares¹³.

The relevant authorities should then address the challenges relating to CCP equity fully bearing losses in resolution. This may include the authority requiring CCPs to amend their capital structures, rules or other governance documents in a manner that subordinates shareholders to other creditors or sets the point at which equity absorbs losses in legally enforceable terms, under the condition that home authorities have the relevant powers.

The authority may also identify or propose changes to applicable national laws, regulations or powers of the relevant supervisory, oversight or resolution authorities that would help meet the resolution objectives or limit the potential for NCWO claims. However, if the jurisdiction's framework does not incorporate such changes, the relevant authorities may need to:

- accept any limitations on CCP equity fully bearing losses;
- include a statement in the resolvability assessment process on their rationale for accepting such limitations (which may include a lack of legal authority);
- identify alternatives to achieve as similar an economic outcome as possible to ensure that equity bears losses in actual resolution (depending on the applicable national framework).

Following these considerations, the FSB recommends that the resolution authority also analyse how this expected treatment of CCP equity could affect (among others):

- the CCP management incentives;
- stakeholders to support recovery and avoid resolution;
- clients;
- the CCP's critical services, business models and legal structures¹⁴.

In the consultation on the FSB's *Guidance on Financial Resources*, CCP12 highlighted that adjusting the treatment of CCP equity in line with the guidance's recommendations could undermine the incentive structure in place that promotes successful default management and recovery processes¹⁵. EACH agreed in the same consultation with the policy objective that the NCWO safeguard does not end up tying the hands of the resolution authorities¹⁶. ISDA published a paper *Safeguarding Clearing: The Need for a Comprehensive CCP Recovery and Resolution Framework* in September 2017¹⁷. In this report, ISDA states that the work on the

¹³ *Guidance on Financial Resources to Support CCP Resolution and on the Treatment of CCP Equity in Resolution*, FSB, 2020, pp. 19-20.

¹⁴ *Guidance on Financial Resources to Support CCP Resolution and on the Treatment of CCP Equity in Resolution*, FSB, 2020, pp. 21-22.

¹⁵ *CCP12 response to FSB consultative document entitled "Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution"*, CCP12, 2020, pp. 1-2, [Response to FSB Consultation on Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution](#).

¹⁶ *Response to FSB Consultation on Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution*, EACH, 2020, p. 11, [Response to FSB Consultation on Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution](#).

¹⁷ *Safeguarding Clearing: The Need for a Comprehensive CCP Recovery and Resolution Framework*, ISDA, 2017, [safeguarding-clearing-final.pdf \(isda.org\)](#).

use of equity in CCP resolution is still ongoing and mentions some key points to consider. These include what the allocation of losses to equity actually means under the applicable resolution strategy and who would own the CCP immediately upon the write-down of equity¹⁸.

The FSB also published its *2021 Resolution Report* in November 2021¹⁹. It reports that from the 13 established CMGs, 8 have started, but not completed, discussing the treatment of equity in recovery and liquidation in the identified hypothetical default loss scenarios and 7 in the identified hypothetical non-default loss scenarios. The report also explains that the FSB will continue to gather evidence and analyse the use, composition and amount of CCP financial resources in recovery and resolution in default and non-default loss scenarios. By the end of 2022, the FSB will submit a status report²⁰.

b. Experience of members of Crisis Management Groups (CMGs)

The Commission asked EU members of CMGs to provide feedback on their initial experiences with these issues.

The general feedback from the authorities was that further analysis was needed and developments would be closely monitored when the CCP-RRR becomes fully applicable. The feedback for now is thus limited in scope and detail, and it may not capture all the relevant issues that may arise in future resolution planning. The points below were made.

According to the EU members, the currently applicable insolvency framework does not make specific arrangements for CCPs. In addition, the default waterfall, for default losses, may not be aligned with the creditor hierarchy in resolution. To mitigate this issue, Article 62 of the CCP-RRR sets out that the full application of contractual obligations or other arrangements in CCP operating rules should be taken into account for calculating the NCWO counterfactual.

The preliminary assessment of other members is that the equity seems fully absorbing without breaching NCWO safeguards or the risk of NCWO claims is limited since the value of continued services, by applying resolution tools, is estimated to be higher than potential losses. The point was also made that resolution strategies that hinge on a strong involvement of clearing members seem particularly suitable to avoid breaking the NCWO counterfactual.

It was also pointed out that, as well as the CCP-RRR that will be soon applicable, work in CMGs on this topic will continue in 2022 in line with the recommendations made in the FSB *2021 Resolution Report*²¹.

¹⁸ *Safeguarding Clearing: The Need for a Comprehensive CCP Recovery and Resolution Framework*, ISDA, 2017, p. 11.

¹⁹ *2021 Resolution Report*, FSB, 2021, <https://www.fsb.org/wp-content/uploads/P071221.pdf>.

²⁰ *2021 Resolution Report*, FSB, 2021, p. 23.

²¹ *2021 Resolution Report*, FSB, 2021, p. 23.

5. The Commissions's assessment

To decide on possible amendments to the write-down and conversion tool and Article 27(7) CCP-RRR, the Commission has to take into account the following:

- the treatment of equity in CCP's current rules and contractual arrangements;
- the envisaged resolution strategy by resolution authorities set down in the preparatory resolution planning phase;
- the practical implementation of the CCP recovery and resolution framework by European CCP resolution colleges;
- the upcoming European Securities and Markets Authority regulatory technical standard on the valuation for applying the NCWO principle;
- ongoing work by the FSB and members of CMGs on this issue.

Resolution authorities have not yet started investigating the current treatment of equity in CCP's rules and contractual arrangements in the course of resolution planning because the relevant rules of the CCP-RRR only become applicable in August 2022. The European Securities and Markets Authority is developing the regulatory technical standards on valuation, which will need a delegated regulation to be adopted by the Commission. The work by the FSB and members of CMGs is still ongoing and currently not sufficiently mature to give a definitive picture on this topic.

The CCP-RRR allows EU resolution authorities to consider and explore all the FSB's options described in the *Guidance on Financial Resources* for the treatment of equity, including:

- changing contractual loss arrangements;
- full or partial write-down of equity;
- transferring critical operations to a bridge entity;
- diluting existing ownership.

This allows the responsible resolution authorities, in coordination with the resolution college, to cater to the specific needs of the individual CCP during resolution planning as well as the individual crisis case when carrying out a resolution. Following this, there are no barriers in the CCP-RRR to allow an appropriate treatment of CCP equity in resolution.

However, more work is needed to ensure that the principle of CCP equity absorbing losses first and being fully loss absorbing in resolution can be applied. Due to the limited practical experience gained and ongoing policy work, the Commission cannot conclude if an amendment of Article 27(7) CCP-RRR is necessary at this time.

6. Conclusion.

In the CCP-RRR, the European Parliament and the Council tasked the Commission to report on the application of the write-down and conversion tool. In particular, the Commission had to determine whether there was a need for any further amendments on the application of the write-down and conversion tool in a CCP resolution, in combination with other resolution tools that result in financial losses being borne by clearing members. The CCP-RRR gives EU resolution authorities the tools to reflect on the issues raised in the FSB's *Guidance on Financial Resources* and thus does not limit policy choices. However, since technical work is still ongoing and practical experience is limited, no recommendation to amend Article 27(7) CCP-RRR can be made at this time.

There is however a need to clarify these issues to ensure the legal robustness of the EU CCP recovery and resolution regime. Further work on this issue will enable a more comprehensive and well-rounded assessment. The conclusions should be shared with the European Parliament and the Council as soon as possible and no later than 12 February 2026 when the Commission should submit the general CCP-RRR assessment report.