

February 1, 2019

Financial Stability Board

***RE: Financial resources to Support CCP Resolution and the treatment of CCP equity in resolution***

On behalf of Americans for Financial Reform Education Fund (AFR Education Fund), thank you for the opportunity to provide comment on this Financial Stability Board (FSB) discussion paper. Americans for Financial Reform is an unprecedented coalition of more than 200 American civil society groups who have come together to advocate for stronger and more effective financial regulation in the public interest. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith-based and business groups.<sup>1</sup>

The discussion paper sets out considerations that might guide national regulatory authorities in assessing whether existing financial resources are adequate for resolution of central counterparties (CCPs), and also considerations on the use of CCP equity in resolution. We commend the FSB for engaging in this exercise. From a public interest perspective, we believe that it is crucial to lay out in advance how the “hard problem” of CCP resolution will be addressed. This is the issue of what will be done if recovery efforts have failed, waterfall resources are exhausted, and a CCP still cannot meet obligations to its participants. National authorities need to lay out expectations for such a situation in a manner that is transparent and clear to both market participants and the general public.

In the absence of such an effort we are concerned that an end-of-waterfall situation will lead to the choice of either imposing losses on parties not prepared to take such losses, possibly destabilizing the financial system, or providing public sector assistance to pay derivatives obligations, creating moral hazard, inequity, and possibly threatening government fiscal health. A failure to make clear what will be done in this kind of situation could encourage private derivatives market participants to believe or assume that they will be bailed out in cases where extreme tail risks materialize.

As the discussion paper points out, there is already FSB guidance available on issues around recovery and resolution.<sup>2</sup> However, we agree with analysts who have pointed out that current guidance is not sufficiently focused on situations where recovery is not possible and CCP functions may not be able to be maintained.<sup>3</sup>

Specifically, the core resolution objectives laid out in the 2017 FSB resolution guidance include all three of the following: maintaining financial stability, maintaining continuity of CCP functions, and protecting taxpayers from risk of loss. These three objectives could easily come into conflict in a situation where recovery efforts are failing and waterfall resources are

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<sup>1</sup> Further information is available at the AFR Education Fund web site, <http://www.realbankreform.org>

<sup>2</sup> Financial Stability Board, “Guidance on Central Counterparty Resolution and Resolution Planning”, July, 2017. Available at <http://www.fsb.org/wp-content/uploads/P050717-1.pdf>

<sup>3</sup> <https://www.imf.org/en/Publications/WP/Issues/2018/03/20/Central-Counterparties-Resolution-An-Unresolved-Problem-45727>

exhausted, particularly if CCP members are not able to absorb additional losses. Both market participants and regulatory authorities especially need better advance understanding about situations in which maintaining the continuity of clearing services carries unacceptable risks of either financial instability or taxpayer loss. If multiple recovery efforts have failed to restore a CCP then it is unlikely that markets will retain confidence in CCP functions without a government backstop that exposes taxpayers to risk of loss. If the best option is to liquidate the CCP and in a way that disrupts clearing services, it will be challenging to maintain financial stability if CCP members or customers are not prepared in advance to absorb losses, possibly lose hedges from derivatives position tear-up, and possibly shift from clearing to bilateral contracts if regulators choose to suspend clearing obligations. Advance transparency about priorities and methods in such situations is critical to meeting these challenges.

We have several suggestions related to the procedures laid out in the document.

- 1) The paper lays out several very high level default loss scenarios. Default scenarios iii and iv (on pages 6-7 of the document) lay out situations in which recovery actions will have to be aborted either because CCP members cannot meet obligations and/or financial authorities believe that further recovery efforts will lead to financial instability. Regulatory authorities should be strongly encouraged to add detail to these scenarios through the use of stress testing for the entire network of CCPs and members, including reverse stress testing to explore scenarios where recovery efforts may lead to financial instability. Both CCP members and customers should be informed of what actions will be taken in such cases.
- 2) Such scenario exploration could be used to assess overall clearing member resources. In particular, capitalization of large clearing members should be viewed in light of possible capital demands in a recovery and resolution situation. Under current rules, clearing members must hold capital against individual positions and also some capital against their share of the default fund. But other mutualized risks or exposures beyond the default fund are not capitalized, including upward adjustments of the default fund in stressed markets, capital assessments beyond the default fund, and the potential need to assume positions from a defaulted member in an auction. All of these possibilities should be examined in the resolution context and this assessment should impact capital requirements for important CCP members.
- 3) The paper implies that it may be difficult to effectively tap CCP equity in a situation where recovery efforts have failed and the market has lost confidence in the CCP. (E.g. the statement on page 22 of the document that “Those who do receive equity may not see it as true compensation for losses suffered.”) This suggests that there should be a greater role for pre-funding CCP skin in the game. In the U.S., the Chicago Mercantile Exchange (CME) currently has a market capitalization of over \$60 billion. However, it appears to pay out almost all of its operating income to shareholders in dividends, approximately \$2 billion annually.<sup>4</sup> CME’s total prefunded default resources (base and interest rate) currently stand at less than \$8 billion, with just \$250 million representing a CME equity

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<sup>4</sup> Based on examination of CME 10-Qs from 2016 to the present.

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contribution. Especially over multiple years it seems that retained earnings could make a much more meaningful contribution to the default fund while still permitting strong levels of dividends. Prefunding additional CCP equity contributions through retained earnings would ensure that current high levels of CCP capitalization are available to actually be used in a timely manner during an extreme stress situation. In the U.S. regulators must approve bank capital distributions through the CCAR process and require earnings to be retained in light of possible future losses. The same principle could be applied to CCPs.

- 4) Finally, we suggest that regulatory authorities examine options for derivatives position tear-up and possibly suspension of clearing obligations in a situation which requires CCP liquidation. Both members and large buy-side clients should be consulted as to their view of such scenarios and the potential impact on financial stability as compared to other steps that rely on maintaining clearing services while tapping members or customers for financial resources to maintain open positions at the CCP.

Thank you for your attention to this letter. We look forward to the opportunity to comment on future guidance related to this discussion paper. If you have questions, contact the AFR Education Fund's Policy Director, Marcus Stanley, at [marcus@ourfinancialsecurity.org](mailto:marcus@ourfinancialsecurity.org) or at 202-466-3672.

Sincerely,

Americans for Financial Reform Education Fund