

17 October 2016

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland

Submitted via email to: fsb@fsb.org

RE: Response to Discussion Note of the Financial Stability Board re Essential Aspects of CCP Resolution Planning

BlackRock welcomes the opportunity to comment on the Discussion Note of the Financial Stability Board (FSB) re Essential Aspects of CCP Resolution Planning dated 16 August 2016 (“FSB Discussion Note”).

We believe central clearing brings many benefits, including increasing transparency for regulators and market participants and eliminates many of the counterparty risks inherent in bilateral OTC transactions. However, along with generating these benefits, central clearing results in certain risks being concentrated in a handful of Central Clearing Counterparties (CCPs).

Throughout this response we put the focus on the perspective of the end-investor - the ultimate user of CCPs - who is committing capital through investment and is required to pay fees to access the benefits of central clearing. There are a number of ways to protect the end-user in clearing, principally through ensuring their protection against losses in the event of CCP recovery or resolution. We welcome a global focus on CCP resolution planning through the ongoing work of the FSB.

1. Executive summary

Asset managers such as BlackRock represent end-users of central clearing of derivatives. CCPs and intermediaries, such as Clearing Members, provide end-users with access to cleared products; they are the owners and operators of the cleared market infrastructure. End-users pay fees to the owner and operators and as such they are a customer of the owners and operators of the cleared market infrastructure.

Much of the financial infrastructure, including CCPs and intermediaries, is operated by for-profit entities which, despite a shared goal of building and operating strong, resilient financial markets, ultimately have to answer to owners, who expect to earn a return on their investment. Sound resolution planning is key to ensuring end-user confidence in clearing and we consider a number of principles to be important to in designing effective CCP resolution toolboxes.

- Minimising the systemic impact of CCP failure should be an overriding consideration. To minimise the market impact of a failed CCP ex-ante, we recommend that a product not be subject to mandatory clearing until at least two CCPs can offer clearing for that product.
- To mitigate and manage the ramifications of a potential CCP failure, CCPs should be required to maintain information systems and controls that can promptly produce the relevant data and information needed to evaluate the state of recovery (the rate at which the loss absorbency resources are being used) and to facilitate the implementation of resolution measures.
- CCP resolution plans should include a pre-funded recapitalisation fund to allow resolution authorities to re-start the services of the CCP in a timely manner. Under

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a new management structure and fully re-capitalised default fund, there is a higher probability that market participants will return to use the new CCP facility relative to one that has been recovered with participants experiencing loss.

- CCPs should explore allowing direct variation margin (VM) payments from end-users to the CCP following a clearing member default. If the infrastructure is in place prior to a clearing member default it could give end-users the possibility to post VM after a default to the CCP directly.

2. Questions

Q1. Does this discussion note identify the relevant aspects of CCP resolution that are core to the design of effective resolution strategies? What other aspects, if any should authorities address?

The discussion note identifies the more important aspects of CCP resolution for swaps and derivatives. It does not address the unique set of issues raised by access to securities finance transaction (SFT) clearing, which we suggest the FSB develops as an annex to its guidelines on CCP resolution.

We would additionally suggest that the FSB also cover how its policy preferences and choices protect the position of the end-investor who is required to use and pays fees for using clearing services. The rights of market participants suffering losses from either partial tear up or the use of variation margins gain haircutting (VMGH) to senior debt claims requires additional discussion with market participants and should be part of the FSB's official guidance.

Incentive effects of resolution strategies

Q2. What is the impact on incentives of the different aspects of resolution outlined in this note for CCP stakeholders to support recovery and resolution processes and participate in central clearing in general? Are there other potential effects that have not been considered?

The right incentives are as important as comprehensive loss absorbency measures. We urge policy makers not to lose sight of incentives created through different options – and seek to reinforce resilience incentives through, for example, skin in the game (SITG) of CCP owners themselves and protecting deposited client money.

Timing of entry into resolution

Q3. What are the appropriate factors for determining timing of entry into resolution? How might a presumptive timing of entry (or range of timing), if any, be defined in light of the criteria set out in the FMI Annex to the Key Attributes? If defined, should the presumptive timing of entry be communicated to the CCP and its participants?

All profit making entities participating in markets, including CCPs, should be allowed to fail while ensuring protections are in place to avoid systemic risk and to protect end-users. A resolution plan that focuses on a rapid and complete wind down of the failing CCP's positions, along with a timely and orderly repayment of margin monies is preferable to a recovery plan that uses customer margin to extend the state of a failed or failing CCP. The exact timing of the wind down should be one area on which international consistency is sought.

A rapid liquidation and return of margin would minimise end-user losses and would allow market participants to have optionality to re-establish positions at a viable CCP, use other instruments to hedge risk or in some cases remain unhedged if the credit exposure to

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CCPs is viewed as greater than the market exposure that is being hedged. Thought should also be paid to the possibility of temporarily removing the clearing requirement to enable market participants to re-establish their hedging trades on a bilateral basis.

By definition, the failure of a CCP reflects a flawed risk management process which in turn will impact customer confidence in the abilities of the CCP on a forward-looking basis. Some may argue that a CCP failure could be the result of unexpected adverse market wide events, and in such a situation a CCP's failure may not be the result of a flawed risk management process. However, given the primary function of a CCP is to appropriately size initial margin, default funds and capital amounts in a manner so as to maintain sufficient resources even in unexpectedly adverse environments, we believe such a failure, even in extreme market conditions, would likely have a significant negative impact on customer confidence in the CCP.

CCP failures will most likely arise where a CCP is unable to secure sufficient interest to cover the positions guaranteed or owned by a defaulting clearing member or where the cost of covering those positions would result in losses that exceed the resources available to the CCP. One way to help mitigate that risk would be to allow creditworthy market participants who are not clearing members to participate in the auction process.

In situations where a clearing member has defaulted, other clearing members may be hesitant to take on additional risk and may not bid aggressively or at all. We do not see any meaningful downside to increasing auction participation and firmly believe expanding the participants eligible to bid in the auction process is highly likely to improve auction results. The criteria for non-clearing member participation in the auction process should be established and published as part of the CCP's recovery and resolution plans, which would allow both the CCPs to identify potential participants and for those participants to take preparatory actions in a measured fashion rather than during the midst of a crisis.

Additionally, end-users could be allowed post-default the possibility to substitute ('buy back') their initial margin in the form of securities with cash. This would be beneficial for the CCP because they would have cash available whereas the end-users, which may be unable to transfer their positions to a back-up clearing member and face liquidation of their positions, could preserve their securities and decrease replacement risk.

Specifically, in terms of the timing of entry into resolution, we would strongly recommend that resolution authorities play a role early in the recovery process before all CCP assets and default resources are exhausted. The resolution authority should then determine whether recovery or resolution of a CCP would be in the public interest and if the CCP had sufficient resources at its disposal to be recovered. If recovery is the chosen option the resolution authority should be responsible for organising another final round of cash calls on Clearing Members before the profits of the end-investor / real economy are haircut.

However, if the resolution authority determines that the recovery measures available to the CCP are not reasonably likely to return the CCP to viability within the timeframe required to enable continued compliance with applicable legal and regulatory requirements, or that they are otherwise likely to compromise financial stability, then the CCP should be taken into resolution.

Adequacy of financial resources in resolution

Q4. Should CCPs be required to hold any additional pre-funded resources for resolution, or otherwise adopt measures to ensure that there are sufficient resources committed or reserved for resolution? If yes, what form should they take and how should they be funded?

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Investor confidence in clearing would be reinforced by a renewed focus on CCP resilience. Robust stress testing of CCPs, additional transparency on CCP risk management practices and increasing the buffer between the 'real economy' and CCP failure by strengthening CCP resources would, in combination, help to reduce CCP failure to the remotest of possibilities. Policy makers should establish harmonised risk capital standards across CCPs, in our view.

We welcome the work already underway at CPMI-IOSCO to review the adequacy of CCP resources as part of ongoing work on CCP resilience and recovery. We encourage policy makers and CCPs to continue this work and believe that CCP resolution planning should anticipate and account for adequate resources in "extreme but plausible" situations upon completion of this work. We also realize and appreciate that CCP resolution would likely occur during a time of extreme systemic distress and that in this situation, additional resources may be required.

To ensure that a failing or failed CCP could be resolved with limited impact on the financial system, CCPs need to strengthen their defences. CCPs can be characterised as for profit entities that carry out the function of public utilities. Higher volumes of cleared trades increase the CCPs revenues but also increase the risk they represent.

Standardised stress tests should be used to test and disclose the strength of the CCP's default resources. A risk-based CCP contribution to default resources would help to ensure CCPs do not take on excessive risk in order to drive revenues. This would ensure that events, such as the default of one or more clearing members, can be adequately buffered by sufficient resources.

Strengthening the "default waterfall" should be a priority. The CCP contribution to loss absorbency should be risk-based – as is the guarantee fund contribution of its clearing members. "Risk" in this context must be more broadly defined than net market risk, which, during normal market operations, a CCP manages to zero. Risk must include how much market risk a CCP could inherit from a clearing member default, in addition to operational risks and credit risk from settlement, custody and investment activities. Replenishment obligations should be legally sound and enforceable so that it is absolutely certain that the surviving CMs can meet their replenishment obligations.

The CCP could be required to contribute more than a minimal amount that is risk-based and measured by the lower of either a fixed percentage of the fund or the largest single clearing member contribution. This risk-based contribution will also indirectly benefit the CCPs ability to maintain a broader and diverse clearing member group and manage concentrated exposure to a single clearing member. Having more SITG will incentivise the CCPs to at all times have robust risk management and would align incentives between the CCP, clearing members and market participants.

Q5. How should the appropriate quantum of any additional CCP resources be determined? In sizing the appropriate quantum, what factors and considerations should be taken into account? Do your answers vary for default and non-default losses?

There have been various estimates of the additional contribution a CCP would be required to make ranging from 5% to 12% of the fund. We would encourage CPMI-IOSCO to include analysis of this aspect in the impact assessment accompanying the finalised global guidelines.

Policy makers should consider requiring CCPs to hold at a central bank an amount equal to its SITG plus one year of regulatory capital (which we believe needs to be recalibrated to absorb losses) and administrative/operating expenses. In the case of default losses, these

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amounts would be reserved exclusively for recapitalization of a new CCP in resolution but it would be appropriate for a CCP to use these resources to cover all non-default losses.

Q6. Should resolution funds external to the CCP be relied upon? If so, how should such funding arrangements be structured so as to minimise the risk of moral hazard, including for CCPs with significant cross-border participation? Where these are pre-funded, how should the target size be determined and which entities should be required to contribute?

The liquidity necessary in resolution should come exclusively from central banks, on standard market terms, including the requirement for high quality liquid collateral. Without access to central banks, liquidity strains would likely compromise CCP resolution and have a negative impact on financial stability. We do not support the use of VMGH or any similar tool for liquidity purposes.

Tools to return to a matched book

Q7. What factors should the resolution authority consider in choosing and exercising tools to return the CCP to a matched book? Is one (or more) of the tools for restoring a matched book preferable over others and if so, why?

The resolution authority should determine if it would be in the public interest to wind down a CCP's critical services. Although it is challenging to identify a specific point of non-viability, it is generally assumed that a CCP will be in resolution after the auction has failed to return the CCP to a matched book. If for some reason resolution commences prior to completion of the auction (e.g., because resolution was necessary to maintain financial stability), then we believe that the resolution authority should have the power to continue the auction for as long as valid bids are submitted.

In the event that an auction fails prior to resolution or in resolution, we support the voluntary use of partial tear-ups to return a CCP to a matched book. Partial tear-ups should also be subject to the approval of all parties – the CCP, clearing members, end-users and the resolution authority. We oppose forced allocation as a means of returning a CCP to a matched book. Forced allocation requires clearing members to take on positions that they may not be suited to risk manage in extreme market conditions.

Clearing participants should reasonably expect compensation in the form of senior debt claims should they suffer losses from partial tear-ups. Without debt claims, these clearing participants would not be "creditors" with respect to such amounts and therefore would not be entitled to protections such as no creditor worse off (NCWO).

Q8. Should any tools for restoring a matched book only be exercisable by resolution authorities? If so, which tools and subject to what conditions?

We favour early intervention by the resolution authorities in CCP recovery. We suggest that once voluntary and committed forms of capital are exhausted, only resolution authorities should oversee loss allocation be it through partial tear-ups to restore a matched book and through other loss allocation tools in recovery and resolution.

Allocation of losses in resolution

Q9. What are in your view effective tools for allocating default and non-default losses and what are the pros and cons of these tools? Should initial margin haircutting be considered as a tool for the allocation of losses in resolution? Is one or more of the tools preferable over others? What are your views on the use of tools to restore a matched book as a means of loss allocation?

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Default losses

End-users of CCPs have been required to use the cleared market infrastructure. End-users do not own that infrastructure and have allocated margin monies in good faith - undermining that good faith by hair cutting initial margin (IM) will lead to perverse systemic consequences which will undermine financial stability.

Allowing a CCP to retain a portion of a non-defaulting participant's IM – the amount a participant is required to post in order to transact – would fundamentally alter the market's view of cleared products. IM of a non-defaulting participant should never be at risk of loss. In our view, allowing a CCP to cover its losses using IM held by or through non-defaulting CMs would be contrary to the spirit and the letter of allowing for client segregation under EMIR.

Non-default losses

Non-default losses are exclusively under the control of CCP management. Therefore, we believe that unlike default losses, clearing participants should not assist in managing non-default losses. Non-default losses should accrue to the ultimate equity holders of the CCP. If CCPs and their shareholders bear the risk of non-default losses, they will be properly incentivized to exercise prudent risk management and focus on CCP resilience.

To cover non-default losses, we believe that CCPs should have prefunded resources held at a central bank or similar institution to cover replenishment of its SITG plus one year of regulatory capital (which we believe needs to be recalibrated to absorb losses) and administrative / operating expenses. We also think that a CCP should have arrangements with its ultimate parent to fund the CCP's recapitalization in a resolution caused by non-default losses. The CCP and its parent should bear the burden of establishing to regulators and clearing participants that the parent would be able to provide such funding.

Q10. Which, if any, loss allocation tools should be reserved for use by the resolution authority (rather than for application by a CCP in recovery)?

While BlackRock does not believe that VMGH would be appropriate in a CCP-led recovery, we believe that the tool could be available for use in resolution with modifications to make use of the tool fair. VMGH losses should be capped and limited to one round of haircutting across all market participants. Participants subject to VMGH should also receive a senior claim against the CCP and its successors for the full amount of the VM taken from them.

If utilized, we believe that VMGH should be applied on a gross (i.e. position level) basis. To apply the tool on a net basis means that the calculation arbitrarily impacts positions that happen to be positive on the days applied and won't impact participants with a flat position at the clearinghouse. There is no reason why narrowing of available variation margin should be applied and to do so treats some market participants worse than others without justification.

Q11. How much flexibility regarding the allocation of losses is needed to enable resolution authorities to minimise risks to financial stability? For example, to what extent should a resolution authority be permitted to deviate from the principle of pari passu treatment of creditors within the same class, notably different clearing members in resolution? What would be the implications of a resolution strategy based primarily or solely on a fixed order of loss allocation in resolution set out in CCP rules vs. a resolution strategy that confers discretion to the resolution authority to allocate losses in resolution differently to CCP rules?

The resolution authority should have constrained flexibility to put the CCP into resolution when it determines in its judgment that: (1) the CCP's return to a matched book require

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extraordinary tools, like variation margin gains haircutting (with safeguards described in Section _ below) or partial tear up (“Reorganization”); or (2) the CCP has reached the “Point of Non-Viability” (“PONV”) if the use of additional efforts and resources will not return the CCP to a matched book (“Wind Up”).

Q12. What are your views on the potential benefits or drawbacks of requiring CCPs to set out in their rules for both default and non-default losses:

- (i) The preferred approach of the resolution authority to allocating losses;*
- (ii) An option for, or ways in which, the resolution authorities might vary the timing or order of application of the loss allocation tools set out in the rules?*

We believe that the sequence of tools set forth in CCP rulebooks and publicly-disclosed resolution strategies should determine how CCP resolution proceeds. A key feature of this process will be to protect the end-investor (“real economy”) from losses by the CCP adhering to the agreed sequencing of recovery tools and ensuring that VMGH is out of the CCP-led recovery toolkit altogether.

While we strongly support adherence to the sequence of tools in a CCP’s rulebook, we recognize that resolution authorities may need flexibility. If this is the case, we believe that publicly-available resolution strategies should clearly articulate what a resolution authority intends to do in various different scenarios. Resolution strategies should also cover how resolution authorities expect to use applicable statutory power together with enforcement of CCP rulebooks.

Non-default losses

Q13. How should non-default losses be allocated in resolution, and should allocation of non-default losses be written into the rules of the CCP?

CCP management should take sole responsibility for non-default losses and unlike default losses, neither clearing participants nor end-users should be required to assist in managing non-default losses. Rather non-default losses should accrue to the ultimate equity holders of the CCP since if CCPs and their shareholders bear the risk of non-default losses, they will be properly incentivized to exercise prudent risk management and focus on CCP resilience.

Risk management would be enhanced if there were additional disclosures to be made around how non-default losses would be handled in recovery or resolution. As per default losses, it is critical for CCP rulebooks and publicly available resolution strategies to address non-default losses.

Q14. Aside from loss allocation, are there other aspects in which resolution in non-default scenarios should differ from member default scenarios?

Non-default losses are highly likely to erode market confidence in the CCP and investor confidence in clearing more generally. The resolution authority should therefore have the power to assess and if necessary replace existing senior management and take other actions necessary to restore market confidence in short order.

Application of the “no creditor worse off” (NCWO) safeguard

Q15. What is the appropriate NCWO counterfactual for a resolution scenario involving default losses? Is it the allocation of losses according to the CCP’s rules and tear-up of all the contracts in the affected clearing service(s) or liquidation in insolvency at the time of entry into resolution, or another counterfactual? What assumptions, for example as to timing and pricing or the re-establishment of the CCP’s matched book, will need to be made to determine the losses under the counterfactual?

The appropriate loss allocation counterfactual should be a liquidation of the CCP.

Q16. What is the appropriate NCWO counterfactual for a resolution scenario involving non-default losses? Is it the liquidation of the CCP under the applicable insolvency regime, assuming the prior application of any relevant loss allocation arrangements for non-default losses that exist under the CCP's rules or another counterfactual?

Non-default losses should be the sole responsibility of the CCP and its shareholders.

Q17. How should the counterfactual be determined in cases that involve both default losses and non-default losses?

For default losses and non-default losses and for cases that involve both, we believe that the appropriate NCWO counterfactual is liquidation under the applicable insolvency regime at the time of resolution.

Equity exchange in resolution

Q18. Should CCP owners' equity be written down fully beyond the committed layer of capital irrespective of whether caused by default or non-default events?

Yes, we believe that shareholders of a CCP should be completely wiped out in a resolution.

Q19. Should new equity or other instruments of ownership be awarded to those clearing participants and other creditors who absorb losses in resolution?

We believe that CCP rulebooks should provide senior debt claims for clearing participants and end-users who suffer losses beyond the CCP's funded and unfunded default resources, in CCP recovery and resolution. This would mean compensating losses incurred through partial tear-ups and variation margin gains haircutting through providing senior debt claims which would be paid with future CCP earnings prior to any such profits flowing to shareholders. If resolution does occur, the claims should be bailed-in for equity as part of a recapitalization. It is crucial that the holders of the senior debt claims have recourse beyond the defaulting clearing member's estate.

Q21. What should be the nature of engagement with authorities in jurisdictions where the CCP is considered systemically important, for the purpose of resolution planning and during resolution implementation?

We believe that authorities should have full transparency into resolution strategies for these CCPs on an ex ante basis and should be in real-time communication with the CCP and the relevant supervisors and resolution authorities in the CCP's home jurisdiction if resolution is contemplated. In order to properly plan for and anticipate a CCP resolution, we also believe that that authorities in all relevant jurisdictions should have full transparency into recovery plans for such CCPs, both on an ex ante basis and on a real-time basis in the event that the CCP exercises its recovery plans. Home resolution authorities should particularly plan and coordinate on an ex ante basis with any third-country authorities who may be required to make quick decisions in the event of a CCP resolution.

Q22. Should CCP resolution authorities be required to disclose basic information about their resolution strategies to enhance transparency and cross-border enforceability? If so, what types of information could be meaningfully disclosed without restricting the resolution authority's room for manoeuvre?

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CCP resolution strategies should be publicly disclosed to the maximum extent possible. At a minimum, clearing members and any other clearing participants that could be expected to support an auction or similar measure for returning a CCP to a matched book should have full access to resolution strategies.

Q23. Does this section of the note identify the relevant CCP-specific aspects of cross-border effectiveness of resolution actions? Which other aspects, if any, should also be considered?

We support the considerations in the Discussion Note, particularly with regard to ensuring cross-border enforceability of rulebook provisions and terms of relationships with custodians and other key counterparties.

Q24. What should be the role, if any, of the suspension of clearing mandates in a CCP resolution and how should this be executed in a cross-border context?

We support the ability of all supervisory authorities to suspend their clearing mandates on an expedited basis (i.e., within 1 day) in the event of distress at a CCP that is eligible to clear products covered by that mandate. This should apply regardless of whether the CCP is actually located in the jurisdiction of the relevant clearing mandate.