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Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
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Dear Mr. Andresen,

Re: **Comment Letter on the Financial Stability Board's Discussion Note Regarding Essential Aspects of CCP Resolution Planning: (16 August 2016) ("FSB Discussion Note")**

The Goldman Sachs Group, Inc. ("Goldman Sachs") is pleased to provide its comments on the FSB Discussion Note. We are fully supportive of the Financial Stability Board (FSB)'s efforts to develop a global framework for resolution planning for Central Clearing Counterparties (CCPs). As mandatory central clearing is implemented across jurisdictions, the role that CCPs play in the global financial system becomes even more significant, as does the critical importance of ensuring that CCPs are effectively managed and clearing only the most liquid products. CCP risk management processes and rules applicable to resolution planning must be carefully considered to ensure that they do not unnecessarily increase systemic risks. In this letter, we provide suggestions for your consideration as to how CCP resolution planning can be designed to, wherever possible, preserve continuity of a clearing service in times of market stress and provide appropriate incentives to market participants to act in a manner that supports such continuity without incurring unnecessary systemic risk. Our suggestions include the following:

- **A Resolution Authority (RA) should be involved in CCP recovery in an oversight and advisory capacity**. The RA should review a CCP's recovery rules ex-ante, alongside clearing members and CCP supervisors. Recovery should be CCP-led and RA intervention should be the last resort, invoked only if there is a risk of compromising financial stability or public interest that cannot be mitigated through a CCP-led recovery

- **CCPs are not banks and the bridge entity concept is inadequate to resolve CCPs.** In times of stress the key risks to the viability of a bank are capital adequacy and liquidity. By contrast, CCPs become distressed as a result of an unmatched book. Restoration of a matched book will not be facilitated by the establishment of a bridge CCP; nor will a bridge CCP help address the underlying risks causing the default management process to fail

- **Use of variation margin gains haircutting (VMGH) should not be limited to resolution only.** Reserving the use of loss allocation tools (e.g. VMGH) for resolution only removes an important economic tool from the recovery process and is contrary to the objectives outlined by CPMI-IOSCO[1] which require a CCP to develop effective and comprehensive recovery tools in order to return to viability on its own

- **Any compensation claims concept should protect incentives for resilience and recovery and not threaten solvency of CCPs.** The industry has for many years promoted limited recourse CCP default waterfalls to prevent risk of disorderly insolvency and mitigate systemic risk. Senior debt claims would be counterproductive in that regard, as they could lead to CCP insolvency

The remainder of the letter explores these four points in more detail.

The design of CCP resolution regimes must take into account the impact to incentives for resilience and recovery

We recognize that regulators must prepare for situations where resolution of a CCP is necessary. In designing a global framework for CCP resolution planning, we encourage the FSB to consider how such guidelines could impact the incentives of clearing participants to meet the regulatory objective of returning a CCP to a matched book and ensuring continuity of service. Ultimately, if certain prescribed resolution tools will produce a result that is viewed as economically more favorable to certain clearing participants (e.g. if the compensation structure rewards certain participants through senior debt claims, or if resolution results in certain participants gaining equity ownership) the motivation of these clearing participants to support default management and the recovery of the CCP can be compromised. In addition, the use of further CCP safeguards – such as a second tranche of "skin-in-the-game" CCP capital as suggested by the FSB Discussion Note[2]– is likely to have a positive impact on incentives for a CCP to ensure the sufficiency of their margin methodology and other risk management practices.

As the FSB Discussion Note recognizes, the concept of early intervention introduces uncertainty and unpredictability of outcome to clearing participants (including clearing members whose main function is to mutualize risk at a CCP).[3]

Providing the right incentives to ensure continuity of service and recovering a CCP should be at the heart of the design of the FSB's CCP resolution planning regime.

CCP resolution planning must account for key differences between CCP and bank resolution

The goal of continuity of service must be viewed in the context of the unique position occupied by CCPs in financial markets, which serves to materially differentiate them from banks. While continuity of critical operations is equally important for both types of entities, banks and CCPs have separate roles in the financial system and manage fundamentally different types of risk. Resolution planning for CCPs must reflect these important differences.

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[1] *"Recovery of financial market infrastructures" Committee on Payments and Market Infrastructures, Board of the International organization of Securities Commissions, October, 2014 (CPMI IOSCO 10/14 Report")*
[2] *FSB Discussion Note , Section 9*
[3] *FSB Discussion Note, Section 3*

The function of a CCP is to act as a central counterparty, and, in doing so, operate a matched book, whereby the CCP serves as the seller to every buyer and vice versa. CCPs mutualize risk through the membership and financial commitments of member clearing firms. The primary risk to a CCP is the default of one or more of such clearing members. Such a default is managed via a predetermined default management process supported by a prescribed default waterfall which draws resources both from clearing members of the CCP and from a limited amount of CCP capital. In times of stress, the key risk to the viability of the CCP is not insolvency, but rather the restoration of the matched book, and, where necessary, loss allocation.
By contrast, banks are in the business of taking market, credit and liquidity risk. In times of stress the key risks to the viability of a bank are capital adequacy and liquidity. When banks become insolvent, they must be recapitalized, and one of the tools to do so is the establishment of a bridge bank, which can absorb the "good assets" of the bank, while leaving other assets behind. When CCPs become distressed, the restoration of a matched book will not be facilitated by the establishment of a bridge CCP. Instead, CCP recovery can and must be accomplished within the existing clearing service.

Furthermore, the establishment of a "bridge" CCP will require significant resources from clearing members (capital, operational, technological) and regulators (licensing, supervising, managing) which will be severely limited in a resolution scenario. Most importantly, since a CCP and clearing participants will be aware that a bridge CCP is available to a CCP in distress, they could be less incentivized to maintain robust resilience and risk management standards if they believe their positions will be transferred without incurring losses. The FSB should encourage regulatory regimes to diversify and allow the use of concepts other than bridge structures during CCP resolution.

Similarly, we are concerned about proposals to require CCPs to adapt their legal structures (e.g. require each clearing service to be a separate legal entity) in order to facilitate resolution of an individual clearing service. We believe that these proposals, which are derived from bank resolution planning, are suboptimal and unnecessary. Implementing such structures could disable cross-margining (the EU's European Market Infrastructure Regulation requires that cross-margined products be in the same legal entity) which helps reduce the cost of clearing. Appropriate CCP rulebook provisions plus the use of partial-tear-up can help resolve the issue of how to resolve an individual clearing service without impacting the larger service.

In determining the timing of entry into resolution, Resolution Authorities should consider the uncertainty and delay that can result from early intervention

We encourage the FSB (and the Resolution Authorities ("RAs") themselves) to consider the unintended consequences of "early intervention" by RAs as a general policy tool.

To clarify, we fully support the assumption that an RA will play a crucial consultative and advisory role both in the review of a CCP's rulebook and in consideration by a CCP, its Risk Committee, and Default Management Group (DMG) of the options available to the CCP during a systemic event. This participation, which must be distinguished from early intervention, will provide assurance to clearing participants that an impartial authority is meaningfully involved in certain complex recovery/pre-resolution processes, such as loss allocation. We encourage RAs to participate in these recovery/pre-resolution processes alongside the CCP as actively and as early as possible.

Certainty and predictability of outcomes are of central importance to clearing participants in order to effectively manage their risks and obligations to a CCP. Where clearing participants cannot quantify with certainty the risks to which they are exposed, they may be motivated to protect their own positions rather than work to ensure continuity of a clearing service. A CCP-led recovery – subject to consultation and advice from the RA – has the best chance of ensuring such certainty and, therefore, recovery and continuity. A CCP's Risk Committee and DMG are comprised of clearing participants who are familiar with the market and can best ensure that hedging of the auction book and other recovery tools are used with minimal market impact. Their direct involvement in the recovery process also safeguards against possible escalation into resolution by providing proper risk management incentives to clearing participants.

Finally, early intervention by an RA could be inconsistent with ensuring speed of decision-making during a default event. It is critical that CCPs are able to act quickly so that market conditions do not interfere with recovery. A CCP-led recovery (subject to consultation and advice from the RA) allows for more expedient decision making by a CCP's Risk Committee as to which tools are most appropriate for a given default situation in light of the market environment at the time.

Significant improvements in CCP resiliency mean that regulators should be cautious about imposing substantial structural changes to CCPs that are both costly and unlikely to be utilized

CCP resiliency has improved significantly since 2008, as a result of both new regulations and the collaboration between CCPs and clearing members to bolster the financial resources available in CCP waterfalls following the default of Lehman Brothers. [4]

We fully support the efforts of CPMI-IOSCO to further strengthen these safeguards and make them more consistent on a global basis. However, we strongly encourage the FSB (and RAs) to properly account for the substantial existing available financial resources at a CCP as they consider CCP resolution planning. CCPs currently maintain significant pre-funded resources to cover extreme tail risks. Existing CCP capital is designed to cover extraordinary and unlikely clearing losses (99% of clearing losses for initial margin, extreme stress moves for default fund), and the types of moves required to exhaust a CCP's default fund (plus assessments) are in a realm of probability that is far beyond "extreme but plausible". Any attempt to provide for greater prefunding of resources for resolution purposes could provide financial disincentives to firms from participating as CCP clearing members and thereby undermine the significant reduction of systemic risk that was contemplated by the reforms of the past several years.

Tools to return to a matched book and allocation of losses in resolution must be included as part of the recovery process

As mentioned previously, in order for a CCP to recover from a default event, such CCP must (with support from its Risk Committee and DMG) re-establish a matched book, using its DMP and auction mechanism. The RA would be involved in this process at all times and provide appropriate and timely consultation and advice to the Risk Committee and DMG. If the CCP-led auction of the defaulted portfolio is successful and results in a valid market price, the CCP

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[4] *These enhancements include: (1) more robust processes around initial margin and stress testing models; (2) increases in pre-funded default funds to more appropriately address the default of multiple clearing members (and associated clients); (3) increases in CCP "skin-in-the-game" (SITG), and (4) the introduction of significant re-assessment powers and cash calls to clearing members.*

should have comprehensive tools available in its rulebook to allocate the realized but finite losses, re-establish a matched book and ensure continuity of service.

It is clear that no party – clearing members, buy-side participants, and the RA itself –is in favor of covering projected default losses if a CCP's funded resources are insufficient. But it is important to remember that the alternative – the lapse of a CCP into resolution and wind down – is a much worse outcome, with the losses incurred by these parties likely to be multiples of those that would be incurred through the use of loss allocation tools, such as variation margin gains haircutting (VMGH).

Loss allocation tools should only be used in extremis – such as when the available funded and unfunded resources are not adequate to cover a CCP's losses after the completion of a successful auction process. Their sole purpose should be to allocate losses after restoration of a matched book, and they should never be used by CCPs as a way to generate liquidity or improve their competitive offering. The involvement of the RA in providing consultation and advice during the loss allocation process should reassure clearing participants that loss allocation processes will be run fairly and with restoration of a matched book as the key objective.

Of the options under consideration, we believe that VMGH (applied in a pro-rata fashion) is the most effective and comprehensive loss allocation tool, and provides the best alternative to ensure continuity. We emphasize that VMGH is an end of the waterfall remedy only, and should be utilized solely in circumstances where the successful auction-established price (to reestablish the matched book) is beyond available CCP resources. When utilized in this manner, VMGH is not only comprehensive – for every loss there is a gain – but it provides the right incentives to clearing participants in a way that supports the CCP's DMP. These include encouraging those with variation margin gains to take the opposite side of the trade (presumably the defaulter's side) and actively bid in the auction.

We note that some commentators have suggested that because VMGH is widely agreed to be an extraordinary tool that can only be utilized at the end of the default waterfall under the limited circumstances described above, its application must occur solely under the direction of a RA, and not a CCP engaged in recovery. Although we understand this concern, we emphasize that VMGH must under all circumstances be considered to be a recovery tool that is designed to promote continuity of service. If limiting its use to the sole direction of a RA implies that it is not available to the CCP to effectively and comprehensively recover on its own, then such limitation is inconsistent with the clear intent expressed by regulators[5]. Clarification of this point is essential to resolution planning and requires a careful analysis of the implications and consequences of the formal commencement of resolution.

Several additional clarifications must be made regarding the use of VMGH. It should not run indefinitely – rather it should be used only as long as the DMP is working, clearing participants have found hedges, and the DMG has discovered a market price during an auction. If the DMG cannot discover a market price for all affected products, the use of partial contract tear-ups may be a preferred alternative to promote resolution of the problematic product or service without contagion to other services. In doing so, partial tear-ups can ensure continuity of a CCP with multiple clearing services versus escalating the entire CCP to resolution where it is not needed.

[5] *"Recovery of financial market infrastructures" Committee on Payments and Market Infrastructures, Board of the International Organization of Securities Commissions, October, 2014.*

Finally, we wish to express our concerns regarding the use of initial margin haircutting (IMHC) under any circumstances as part of a recovery or resolution process. This tool fundamentally undermines the regulatory objective of continuity of service. Initial margin is a function of the risk a clearing member has at a particular CCP. The knowledge that initial margin could be at risk in recovery or resolution could lead members to start reducing their risk position at the clearing house. Simply, IMHC creates the problematic incentive for clearing participants to run to for the exit – away from the CCP – to protect their initial margin and in the process avoid a CCP's loss allocation process which aims to restore a matched book. The incentives for clearing participants to manage their unprotected initial margin also mean that they are less likely to offer hedges or bids in auctions, thereby jeopardizing the CCP's ability to restore a matched book. Finally, IMHC is unlikely to be nearly as comprehensive as VMGH (in that it may not be sufficiently large to cover losses). [6]

Conclusions

We hope you find the suggestions contained in this submission helpful. We welcome further engagement with the FSB and global regulators on this important topic and look forward to continuing discussions.

Yours sincerely,

John F.W. Rogers

[6] *ISDA April 17, 2015 Comment Letter on Initial Margin Haircutting*