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Secretariat to the Financial Stability Board
c/o Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

By email: fsb@fsb.org

RE: Discussion paper on financial resources to support CCP resolution and the treatment of CCP equity in resolution

Dear Sir or Madam,

ICI Global¹ appreciates the opportunity to comment on the Financial Stability Board's (FSB) discussion paper (DP) on financial resources to support the resolution of a central counterparty (CCP) and the treatment of CCP equity in resolution.² We support the FSB's objective of issuing guidance to maintain market confidence and promote a consistent international process for CCP resolution. If implemented appropriately, this guidance could reduce uncertainty in the event of a CCP's failure and assure market participants that they will receive fair treatment from resolution authorities.

ICI Global members – regulated funds³ in jurisdictions around the world – use centrally cleared derivative contracts in a variety of ways to achieve their investment objectives in accordance with the terms of each fund's prospectus.⁴ The increased use of cleared derivatives by market

¹ ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US\$28.9 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

² Financial resources to support CCP resolution and the treatment of CCP equity in resolution, Discussion Paper, Financial Stability Board, 15 November 2018, available from <http://www.fsb.org/wp-content/uploads/P151118-2.pdf>.

³ For purposes of this letter, the term "regulated fund" refers to any fund that is organised or formed under the laws of a nation, is authorised for public sale in the country in which it is organised or formed, and is regulated as a public investment company under the laws of that country. Generally, such funds are regulated to make them eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds typically are subject to substantive regulation in areas such as disclosure, form of organisation, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or "eligible assets," concentration limits and/or diversification standards). Examples of such funds include: US investment companies regulated under the Investment Company Act of 1940; EU "Undertakings for Collective Investment in Transferable Securities," or UCITS; Canadian mutual funds; and Japanese investment trusts.

⁴ Derivatives are a particularly useful portfolio management tool in that they offer regulated funds considerable flexibility in structuring their investment portfolios. Uses of derivatives include, for instance, hedging positions,

participants should be supported by an effective regulatory framework for CCP oversight by relevant authorities, ideally based upon international standards, including procedures to address the failure and subsequent resolution of a CCP.

We therefore strongly support the FSB's efforts to issue guidance on CCP resolution and the financial resources available to support a resolution proceeding. Through its guidance, the FSB should seek to strike a balance between providing certainty regarding the resolution process and allowing resolution authorities sufficient flexibility to respond to unanticipated circumstances. We further recommend that the guidance ensures that regulated funds and other customers of CCPs receive fair treatment during a CCP's resolution. To accomplish this objective, we urge the FSB to adopt guidance that:

- at a minimum, encourages authorities to communicate to clearing participants the tools and strategies they will use to resolve a failed CCP (see Section I below);
- establishes that a CCP enters resolution at the point when it has depleted its own recovery resources and the resources of clearing members that are committed to the CCP's recovery (see Section II below); and
- supports the use of resolution strategies that rely on the resources of the entities ultimately responsible for the failure of the CCP's risk management function—the CCP itself and its members and shareholders—rather than seizing resources from non-defaulting customers, CCP users that play no meaningful role in CCP risk management and have not contributed to the CCP's distress (see Section III below);

These recommendations, which we discuss in more detail below, also will: (i) provide greater certainty to market participants; (ii) improve market confidence; and (iii) support the achievement of global post-crisis political commitments, including encouraging greater clearing of OTC derivatives.

I. FSB's Guidance Should Encourage Authorities to Provide Transparency into Resolution Tools and Strategies

The FSB should encourage national regulators and resolution authorities to communicate to clearing participants the scope of the tools and strategies they will use to resolve a CCP. The FSB should recommend, at a minimum, that authorities communicate: (i) a definition of when a CCP resolution begins; (ii) the likely steps that a resolution authority would take to resolve a CCP; and (iii) the resources they expect to finance each step of resolution. Communicating these details to clearing participants should reduce uncertainty, build trust, and promote fair treatment for all stakeholders, should a resolution plan ever be activated.

As we have respectfully suggested previously,⁵ authorities could achieve this level of transparency by making public the full text of CCP resolution plans or a summary of the material portions of each plan. This disclosure should include the five-step process proposed in the DP for the evaluation of the financial resources and tools for resolution, if this is adopted by the FSB. We suggest that the FSB's final guidance demonstrates a genuine commitment to achieving

equitizing cash that a regulated fund cannot immediately invest in direct security holdings, managing a regulated fund's cash position more generally, and adjusting duration.

⁵ See Letter from Dan Waters, Managing Director, ICI Global to Secretariat of the Financial Stability Board, Re: Guidance on Central Counterparty Resolution and Resolution Planning – Consultative Document, dated 13 March 2017, available at <http://www.fsb.org/wp-content/uploads/ICI-Global.pdf>.

meaningful transparency to reduce uncertainty and maintain market confidence during CCP resolution. Market participants that understand a clear plan exists to resolve a failing CCP and have confidence the plan will be followed will feel more assured of the next steps upon the activation of the plan. Their responses should be measured and proportionate to the risks that the plan presents to their business. If, however, market participants question whether authorities have a plan to resolve a financially distressed CCP, lack adequate information concerning the risks that a resolution plan presents to their business, or believe authorities will abandon the plan, they would have every incentive to exit the market at the first sign of CCP distress, possibly exacerbating stress at the CCP.

II. FSB Guidance Should Clarify When Resolution Begins to Ensure that Assessments of the Adequacy of Resolution Tools and Resources Starts at a Common Point (Question 1)

The DP's first question seeks input on the five-step process that authorities should take to assess the adequacy of financial resources for a CCP's resolution. But when would a resolution begin? Much of the five-step analysis depends on knowing the answer to this question. Ideally, the FSB's final guidance on CCP resolution will answer this question clearly to ensure that global authorities start their assessment in a comparable place, regardless of the jurisdiction of the CCP or the regulators supervising it. Moreover, an internationally consistent approach has the potential to bolster market confidence by managing the expectations of investors and market participants and reducing the risk of sudden market withdrawal which in turn may exacerbate market stress. Accordingly, we urge the FSB to include in its guidance a clear and objective threshold for the commencement of resolution proceeding.

We recommend that FSB guidance defines this threshold as the point at which a CCP has depleted its own resources and also the resources of clearing members that are committed to the CCP's recovery (i.e., resources established under prudential requirements designed to ensure that a CCP can meet its obligations, including the CCP's own capital and clearing member guaranty fund deposits). At this stage, the CCP cannot continue to provide clearing services without external funding and the most likely sources for this bail out are the funds of clearing participants, CCP creditors, or taxpayers. From this point, the resolution authorities should determine whether to provide additional funding to the CCP under the auspices of a resolution plan.

III. FSB Guidance Should Protect Assets of Non-Defaulting Customers (Question 5)

We are concerned that the DP fails to incorporate meaningful protections for non-defaulting customer assets into the assessment of financial resources for CCP resolution. In the discussion of default loss scenarios, for example, the DP notes that "key areas for consideration" include variation margin gains haircutting and full or partial contract tear ups.⁶ The DP also contemplates that initial margin might be available to a resolution authority, at least in some circumstances.⁷

Margin haircuts and contracts tear ups pose a serious risk to non-defaulting customers of clearing members, and we strongly urge the FSB to discourage their use. To affect a tear-up, a CCP would cancel some or all of the exposure associated with a particular contract, reducing the CCP's

⁶ DP at 10-11.

⁷ See *id.* at 16 (asking whether non-bankruptcy remote initial margin be available and would the resolution authority have the power to write it down).

exposure and helping it return to a matched book at the expense of the contract holder, which loses the rights that it had negotiated and paid for when the CCP accepted the contract for clearing.⁸ Similarly, margin haircutting would allow a CCP to seize assets from non-defaulting customers. Variation margin gains haircutting (VMGH) contemplates reducing pro rata the amount that the CCP would be obligated to pay participants with in-the-money (net) positions while continuing to collect in full from those participants with out-of-money (net) positions. Initial margin haircutting occurs when a CCP writes down initial margin provided by a non-defaulting clearing participant and requires that participant to replenish the initial margin.

Put simply, contract tear ups and margin haircuts are a mechanism to transfer assets of non-defaulting customers to the CCP and its shareholders. We urge the FSB not to sanction the ability of a CCP or resolution authority to seize these customers' assets to support CCP resolution. As set out in more detail below, this policy will have undesirable ramifications, including discouraging voluntary clearing and encouraging questionable risk management practices at CCPs.

A. Seizing customer assets would discourage voluntary clearing and encourage questionable risk management practices

We urge the FSB to consider carefully the incentives that its guidance will create for all CCP constituencies, including customers, owners, managers, and clearing members. We respectfully suggest that the guidance insist that CCP resolution plans advance the G-20's commitment to increase central clearing of derivatives contracts. Resolution plans that authorise margin haircuts or position tear-ups will discourage regulated funds and other CCP customers from voluntarily clearing their derivatives trades by introducing risks that do not exist in uncleared derivatives products and that they cannot monitor or control.⁹ Both of these tools would allocate losses to parties that have not contributed to a CCP's distress but happen to have their assets available to the CCP when its risk management function fails and it needs additional funds to continue operations. Regulated funds and other customers of clearing members play no meaningful role in the risk management process of a CCP and do not share in the profits of the CCP's business. The only way that they can mitigate the risk of a CCP seizing their assets is to reduce their use of the CCP by curtailing the practice of voluntarily clearing derivatives not subject to a clearing obligation or increasing their use of derivatives not mandated for clearing.

Permitting the use of customer funds—especially initial or variation margin—to finance a CCP's resolution also could provide an incentive for CCPs and their clearing members to take risks that they otherwise would not take if only their assets were available in the event of a failure. The misalignment of incentives that results from this moral hazard is somewhat similar to bailouts using public funds, which policymakers want to avoid. In either case, a CCP's owners and managers would know that third-party funds could be available to subsidize overly aggressive risk taking.

Our concerns about moral hazard are heightened because the DP does not provide clear guidance on the role of a CCP's owners and managers during and after resolution. If the

⁸ We do not object to tear-ups that occur as a result of the wholesale liquidation of a CCP, provided that contracts are torn up quickly and in an orderly fashion and that non-defaulting customers of clearing members receive promptly all proceeds due to them following the liquidation of their contracts.

⁹ A regulated fund can, for example, use a third-party custodian to remove the ability of a bilateral counterparty to seize its initial or variation margin in the absence of a default by the fund.

possibility exists for the same group that led a CCP into ruin to continue to control the enterprise following resolution or for the equity owners to remain unaffected and retain their ownership stake following a resolution proceeding, the provision of customer funds as a resolution tool could create perverse motivations for a CCP's owners and managers.¹⁰

Ultimately position tear-ups and margin haircuts would weaken the central clearing system rather than making it more robust to market shocks by reducing the willingness of customers to use cleared products and introducing moral hazard into CCP risk management decisions. Although the FSB likely does not intend to cause these consequences, they flow logically from the DP's endorsement of tools that use customer assets to fund CCP resolution. We acknowledge that appropriating customer assets looks easy—a CCP, after all, already holds these assets—but permitting margin haircuts and position tear-ups is a policy choice that could have negative ramifications for the financial system. The FSB should consider the incentives that resolution tools will create for all parts of the clearing ecosystem and endorse only those tools that will support prudent CCP risk management practices and greater use of central clearing services.

B. Resolution plans should encourage the use of resolution tools that do not entail the use of non-defaulting customer assets to strengthen the financial system

Rather than sanctioning the appropriation of customer assets to resolve a failed CCP, we urge the FSB to recommend that resolution authorities adopt resolution strategies that allocate losses to, and provide for replenishment of financial resources by, those market participants that caused or contributed to a CCP's failure, that can control the amount of risk they bring to or allow in the CCP (as clearing members or owners), and that have the ability to monitor or manage the CCP's risk-taking and management activities.

The FSB has previously¹¹ identified a variety of resolution strategies that would not involve seizing customer assets, including: (i) imposing losses on CCP owners; (ii) enhancing CCP contributions to recovery efforts; (iii) selling new equity in the CCP and using the proceeds to replenish its financial resources; and (iv) setting aside additional pre-funded resources for use in resolution beyond those already stipulated in the regulatory requirements for CCPs. We note that several of these strategies are acknowledged in the DP¹² and urge the FSB to incorporate these options into its final guidance so that resolution tools properly align the interests of those managing CCP operations and their risks with those of other CCP participants. Guidance that makes clear that CCPs and their owners and clearing members are expected to fund the CCP's resolution would incentivise CCPs and their owners to manage risk appropriately while simultaneously encouraging regulated funds and other market participants to increase their use of cleared OTC derivatives.

If the FSB, however, is unwilling to rule out the use of customer assets to bail out a CCP, it should, at a minimum, constrain their use to a tool of last resort that can be accessed only: (i) after other tools have been exhausted; and (ii) if authorised and supervised by a resolution

¹⁰ DP at 25 notes the potential of a change in ownership of a CCP, for instance resulting from the imposition of losses on equity and subsequent recapitalisation, to impact on other entities within a CCP's group which could include trading platforms, central securities depositories and other CCPs.

¹¹ Guidance on Central Counterparty Resolution and Resolution Planning, Consultative Document, 1 February 2017, available from <http://www.fsb.org/wp-content/uploads/Guidance-on-Central-Counterparty-Resolution-and-Resolution-Planning.pdf>

¹² DP at 11.

authority. The methodology and process for appropriating customer assets should be non-discriminatory, transparent, and subject to pre-determined caps, and customers must be compensated for their loss. These measures would mitigate, but not certainly entirely eliminate, the extent of the moral hazard with the use of such tools and the potential for the final guidance to discourage clearing. The DP's acknowledgement that constraints on contract tear ups and VMGH could be "considered" as part of the assessment of a CCP's resolution resources and tools falls far short of this standard.¹³

The FSB's final guidance also should limit any use of customer assets to scenarios involving default losses (i.e., losses caused by the default of a clearing member). A CCP and its shareholders should bear all responsibility for non-default losses because these losses result directly from business decisions of the CCP's management. The CCP's management is the only group able to control and mitigate the CCP's exposure to these losses. When a CCP and its shareholders exclusively bear the risk of non-default losses, they will be incentivised to make arrangements in advance to address non-default losses. We appreciate that the DP does not directly reference the use of customer assets for non-default loss scenarios, but the FSB's final guidance should expressly rule out their use in such circumstances.

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We appreciate the opportunity to provide input on the DP. If you have any questions on this letter, please contact myself, Jennifer Choi, Chief Counsel, ICI Global on +1 202 326 5876 or at jennifer.choi@iciglobal.org, or Giles Swan, Director of Global Funds Policy, ICI Global on +44 207 961 0832 or at giles.swan@iciglobal.org.

Yours sincerely,

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Managing Director

¹³ DP at 10-11.