

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

Submitted via e-mail to: fsb@fsb.org

July 31, 2020

Re: Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution

Dear Sir or Madam,

ABN AMRO Clearing Bank N.V.; Barclays; BlackRock, Inc.; Citigroup Inc.; Credit Suisse AG; Deutsche Bank AG; Franklin Templeton; Ivy Investments; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Societe Generale S.A.; TIAA; T. Rowe Price; UBS AG; and The Vanguard Group appreciate the opportunity to comment on the Financial Stability Board's (FSB) consultative document on "Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution" (the "Consultation").

I. Executive Summary

We appreciate the FSB's commitment to develop guidance for a resolution framework that would promote resolvability and ensure consistency across jurisdictions. We support the FSB's focus on enhancing global financial stability, emphasis on the need for addressing systemic risk by coordinating with supervisors of clearing members, and commitment to undertake quantitative work to evaluate adequacy of resources. We are encouraged that the FSB recognizes the moral hazard concerns presented by allowing CCP equity to survive a resolution process and is proposing alternate approaches such as modifying loss allocation arrangements and diluting existing ownership by raising new capital to address these concerns.

Nevertheless, while acknowledging the financial stability impact of resolution tools and the potential for their use concurrently by several failing CCPs, we believe that the guidance should go further in:

- encouraging the transparency of resolution plans and resources to both the market and the regulatory community to ensure that exposures of clearing participants are transparent, predictable, and measurable;
- ensuring the adequacy of financial resources for resolution, both to absorb losses and to provide for the continuity of clearing services;
- restricting the number of clearing member cash calls to absorb losses, requiring that any use of VM haircutting or partial tear-ups be subject to limits, be overseen by regulators, and be compensated by the CCP; and prohibiting the use of IM haircutting;
- mandating the use of residual CCP capital in recovery, providing for compensation for use of resources (beyond a recovery cash call equal to the default fund contribution (1xDFC)), and prescribing a requirement for CCPs to

maintain prefunded resources for recapitalization, which can together ensure that CCP shareholder equity is not protected in the resolution process.

We are concerned that the absence of more specific guidance could lead to significant differences in CCP resolution regimes across jurisdictions, compromise the resolution process and defeat the intent of many of the FSB Key Attributes principles, including that equity should be fully loss absorbing in resolution.

II. Introduction

We appreciate the FSB's work on the important topic of the use of financial resources in CCP resolution and the FSB's enduring commitment to developing a thoughtful resolution framework that is applied consistently across jurisdictions.

The FSB's continued efforts, including through the 2017 *Guidance on Central Counterparty Resolution and Resolution Planning* and the 2018 *Financial Resources to Support CCP Resolution and the Treatment of CCP Equity in Resolution*, and partnership with the Committee on Payments and Market Infrastructures ("CPMI") and the International Organization of Securities Commissions ("IOSCO"), have been integral in highlighting considerations around key areas of potential systemic risk, including cross-jurisdictional cooperation through crisis management groups ("CMGs"), and the financial stability implications of the use of certain resolution tools.

Many of the recommendations from our March 2020 white paper, "[A Path Forward for CCP Resilience, Recovery, and Resolution](#)," ("CCP White Paper"), are directly relevant to the FSB's work. While the Consultation is focused on resolution, we believe it is critical to keep a lens on the concept of resilience at all times, and as such we refer to some resilience-related recommendations throughout our response. Similarly, we refer to our recommendations in support of recovery as we believe our overall approach serves to enhance the likelihood for the success of the resolution process.

In September 2009, leaders of the G20 nations agreed that to reduce systemic risk, standardized over-the-counter ("OTC") derivatives contracts must be cleared through central counterparties ("CCPs"). Today, most standardized OTC derivatives transactions have migrated to central clearing. Central clearing provides regulators with improved risk transparency and has also served to reduce credit risk through a more comprehensive approach to netting and collateralization.

However, it has also centralized credit and operational risk in a small number of systemically important institutions. Many CCPs have market shares well in excess of 50% for a particular asset class. Moreover, the market dynamics of trading and clearing have resulted in the formation of natural monopolies, where liquidity is concentrated in only a handful of CCPs. This exposes the global financial system to a small number of potentially significant points of failure.¹

¹ The importance of CCP resilience was emphasized by the large mutualized loss experienced in the Nordic power markets in September 2018, with two-thirds of a CCP's default fund consumed by a single clearing member default. While the CCP proved resilient, the loss allocation defied expectations and provides an opportunity to learn and make adjustments.

It is imperative that relevant authorities consider this market dynamic when developing oversight plans, as the forces of market competition that may serve as a natural check on excess risk in other industries are generally not applicable when looking at cleared markets. There are currently a limited number of CCPs in the market within a given asset class, with limited substitutability between them.

Furthermore, CCPs' structures have evolved from mutualized ownership to for-profit public companies, whose objective of creating value for shareholders must be considered by authorities in developing resolution plans. As discussed below, this shift in CCPs' ownership framework creates a misalignment of incentives that can lead to unduly emphasizing shareholder returns over bolstering the safety and soundness of CCPs as providers of critical market infrastructure. The fact that CCPs currently only contribute a small amount of their own capital to address losses raises further concerns over alignment of incentives.

Given this market dynamic, we fully support FSB's suggestion that authorities consider whether there are alternative CCPs available to participants when evaluating existing resources and tools available in the resolution of a CCP. Clearing members and end-users do not typically have the option to choose alternative CCPs when they have concerns with the structure or risk management at a particular CCP.

III. Assessing the adequacy of financial resources to support CCP resolution.

Part I of the Consultation explores the adequacy of financial resources to support a CCP's resolution. We are supportive of the FSB's aim to ensure a robust and regularly reviewed resolution plan to address both default and non-default loss scenarios as we believe that clear, credible, and transparent resolution plans are critical should resilience and recovery measures fail. To ensure that risks for clearing members and end-users are transparent, predictable, and measurable, there needs to be enhanced CCP transparency of the risks presented by their platforms, and CCPs need to be appropriately capitalized to adequately address such risks.

To that end, we are supportive of the five-step process set out within the Consultation; however, we offer some recommendations that we believe could further strengthen the resolution planning process and provide greater certainty for market participants in times of stress.

A. Transparency of Resolution Plans

Transparency to Market Participants and Appropriate Governance Structures

The Consultation suggests a number of factors that resolution authorities should consider that would increase the transparency of CCPs' resolution plans to both clearing members and end-users. Specifically, the Consultation suggests authorities should consider the impact of, and provide for the transparency of, additional cash calls on clearing members.² They expand this to include transparency through to the end-user, and "how these tools may affect clients."³ We think this transparency is critical to market participants, who are

² Consultation: Part I; Section 5.2

³ Consultation: Part I; Step 2

currently unable to fully understand their financial exposure to CCPs, and necessitates governance structures that consider the views of clearing members and end users.

More specifically, in resilience and recovery, CCPs' governance arrangements should be clearly defined and require CCPs to obtain and address clearing member and end-user feedback and for such feedback to be disclosed to regulators. This would provide relevant authorities with important market views that could help improve resilience, recovery, and resolution measures.⁴ In addition, given the market dynamic described above, in order to ensure appropriate decision making around the use of various tools, regulators should require that a CCP's board of directors⁵ makes decisions that balance the CCP's role as a provider of critical market infrastructure with its obligation to earn returns for shareholders. Also, given the impact that a CCP's rules may have on the financial system and broader economy, any rule or procedure that may increase systemic risk (such as loss allocation provisions and wind-down rules) should be subject to pre-approval by the resolution authority and/or systemic risk regulator in addition to the CCP's primary regulator. Finally, to limit uncertainty, CCP rulebooks should make clear that emergency powers, which are often broad and vaguely defined, be reserved for extreme circumstances and subject to consultation with the CCP's regulator.

In addition to enhanced transparency of resolution plans, current disclosure requirements should be expanded to ensure that clearing members and their end-users can estimate the likelihood and potential impact of the use of resolution tools. The PFMI and subsequently published guidance set out quantitative and qualitative disclosure standards for CCPs.⁶ These releases acknowledged that to permit robust diligence on CCPs, CCPs should supplement these standards with additional detail as needed.

Unfortunately, several CCPs have not adequately adopted the PFMI disclosure standards, and the published guidance has not been implemented in many jurisdictions. Existing CCP disclosures thus continue to be limited by a lack of detail, are often inconsistent across CCPs, and are prone to reporting errors⁷. Regulators should mandate greater standardization of disclosures across CCPs and implement audit requirements to ensure that disclosures are accurate, clear, and consistent. Enhanced public disclosures should include supporting details (including explanatory text) and be provided to both clearing

⁴ Such consultation should be separate from risk committees (which can include employees from both clearing members and end-users) because those committees' members generally have duties that preclude them from representing their employers

⁵ CCP management may make decisions to the extent that powers are delegated by the board in line with recommendations included within Resilience of Central Counterparties (CCPs): Further Guidance on the PFMI.

⁶ These other releases are Public Quantitative Disclosure Standards for Central Counterparties and Principles for Financial Market Infrastructures: Disclosure Framework and Assessment Methodology. These releases require CCPs to provide, among other information, quantitative data regarding the sizing of the CCPs' IM and default fund requirements and descriptions about how the CCPs address each of the PFMI.

⁷ For example, with respect to the Principles for Financial Market Infrastructures Disclosures (PFMI Qualitative Disclosures), CCPs provide varying levels of detail and publish with different periodicity – some publish annually while many publish biennially. With respect to the CPMI-IOSCO Public Quantitative Disclosures, while most CCPs publish data in a standardized format that follows the CPMI IOSCO guidance, the data fields themselves can be subject to interpretation, with some fields being reported at a clearing service level and others at a more macro CCP level, making it difficult to compare the data across CCPs.

members and end-users; they should thoroughly cover CCP risk methodologies, back testing, stress testing and, importantly, clearing member and end-user loss allocation tools.⁸

Transparency to Resolution Authorities

Given the interplay between resilience, recovery and resolution, as well as the global interconnectedness of the financial system, consistency of frameworks and transparency among resolution authorities is critical. To that end, we support the FSB's 2017 guidance on establishing a CMG to coordinate resolution planning for CCPs that are systemically important in multiple jurisdictions.⁹ For such CCPs, the Consultation suggests annual reviews and updates to assessments for determining adequacy of financial resources and of treatment of equity in resolution which we fully support.

We are encouraged that the Consultation envisages the resolution authority working with the CCP's oversight and supervisory authority in determining adequacy of resources and discussing the results with the CMG. We believe that to affect a resolution with minimal systemic disruption, the relevant resolution authorities should regularly review the relevant CCP's rulebook in conjunction with the CCP's primary regulator and systemic risk regulator to ensure a common understanding and coordinated approach to a CCP's risk management, default management process, governance, policies, and key procedures.

However, the proposed guidance should go further. It should require consistency of frameworks across jurisdictions and transparency of resolution plans prepared by resolution authorities. Ensuring consistency and increasing transparency would enhance predictability and enable clearing members and end users to estimate the likelihood and circumstances under which various resolution tools would be required and assess their cost implications. Similarly, the guidance is silent on resolution playbooks developed by resolution authorities and related simulation exercises.

We recommend that guidance should extend beyond scenario analysis and include the development and testing of playbooks, simulation of resolution, and default scenarios with cooperation across resolution and supervisory authorities including CMGs. Where a CCP's activity spans multiple jurisdictions, the resolution authorities, systemic risk regulators, and the CCP's primary supervisors should work with corresponding foreign authorities to test playbooks and simulate resolution and default scenarios through CMGs to demonstrate how the CCP and its resolution authority will continue operations in resolution.

B. Adequacy of Financial Resources

Loss Absorbing Resources vs. Financing Resources

The Consultation suggests that the resolution authorities should undertake an evaluation of the existing financial resources and tools to assess whether a CCP would be able to

⁸ Examples of enhanced disclosures include aggregate CCP-level and anonymized member-level back testing, excluding concentration and liquidity add-ons, back-testing results for individual products (as opposed to overall portfolios) so as to identify potentially under-margined products, the distribution of uncollateralized stress loss on an anonymous basis, and explanatory text that addresses material data moves and inconsistencies, such as timing mismatches between data points.

⁹ Consultation: Introduction.

facilitate an orderly resolution.¹⁰ We believe it is important for this purpose to differentiate between “loss absorbing” and “financing” resources.

Loss absorbing resources from market participants should be limited to the defaulter’s margin and the member default fund (including a 1x DFC assessment) that are meant to ensure resilience and facilitate recovery of a CCP. Resources that are used beyond loss absorbing resources should be considered financing resources that are meant to return a CCP to viability. The distinction between the two is important given the ownership structures and market dynamic we discussed above. Any externalization of losses to market participants (beyond the above stated loss absorbing resources) should be recoverable by those that contribute resources to cover such losses through predefined equity-like instruments that would not render the CCP insolvent but would place the claims of participants ahead of the claims of shareholders. Such compensation claims should be retained in the case of resolution.

This distinction in treatment between loss absorbing and financing resources will have a real impact on financial stability during both recovery and resolution as it will incentivize market participants to stay in their trades, rather than liquidate. “Adequacy” must be viewed through a lens of “availability” and absent compensation for financing resources, as is currently the case, the expected providers of those resources are not incentivized to provide them.

Key Considerations in Evaluating Existing Resources and Tools

The Consultation suggests a number of factors resolution authorities should consider when assessing the adequacy of a CCP’s financial resources and whether certain gaps should be addressed, including “...the specific types of products cleared, arrangements for loss-sharing or segmentation across different clearing services, and CCP ownership structures on the availability of the various potential loss absorbing resources in resolution.”¹¹ We believe all of these items are important, particularly:

- *Implications arising from the specific types of products cleared:* This factor underscores the interplay between resilience, recovery and resolution that we indicated at the beginning of this discussion. The liquidity and the volatility associated with the products cleared would directly impact the adequacy of financial resources in resolution. As a result, we recommend that the FSB work with CPMI and IOSCO to limit clearing by a CCP to sufficiently liquid products with adequate market capacity to reliably absorb the risk of its largest participants should one or more of them default in times of stress. To support product innovation, new products could initially be backstopped by a CCP’s shareholders, who benefit financially from the upside of such product innovation, until the products meet such criteria.
- *CCP ownership structures:* As mentioned in the introduction, many CCPs have evolved from market utilities with mutualized ownership structures to for-profit public companies that must maintain returns to shareholders. This creates potential incentive problems, where clearing members and market participants could disproportionately bear losses while providing above-average returns to shareholders who may be artificially insulated from the negative consequences of

¹⁰ Consultation: Part I, Step 2.

¹¹ Consultation: Part I; Step 2

poor risk management decisions. This potential incentive misalignment is exacerbated by a CCP's natural monopoly structure. These market structure issues should be considered by resolution authorities when considering the availability of resources as well as the origin of these resources.

C. Cash Calls

The Consultation recommends that resolution authorities evaluate cash calls when assessing available resources for default loss scenarios, including evaluating financial stability implications of cash calls and the possibility of multiple concurrent cash calls from several CCPs.¹² The Consultation further recommends authorities evaluate how cash calls can be “measurable, manageable, and predictable.”¹³ It also rightly recognizes that availability of resources would vary depending on whether they are prefunded, committed, or uncommitted and acknowledges that there is a need for discounting any uncommitted or unfunded resources.

We recommend there be an explicit requirement for cash calls to be capped across recovery and resolution. CCPs should not be permitted under local regulatory regimes to make unlimited assessments on members, for either a single default or across multiple defaults, without allowing clearing members the opportunity to withdraw from the CCP and cap their liability. A CCP should only be permitted to assess over a reasonable period, covering sequential defaults, an amount of cash from each clearing member that is no greater than the clearing member's default fund contribution (1xDFC) immediately before the default. This would limit the pro-cyclical effect of assessments, enabling members to measure and manage their exposures and reduce the likelihood that the assessments lead to systemic risk or a liquidity crunch.

We further recommend that an additional cash call (beyond the assessment mentioned above) be made available to a CCP only after a super-majority of clearing members vote to provide additional financial support, which would provide an additional 1xDFC of resources. This would be a critical inflection point for the CCP as clearing members would weigh the value of maintaining their trades (at the cost of another cash call) against the potential losses from unwinding all positions.¹⁴ A failed vote would provide resolution authorities valuable insight into market confidence and ongoing viability of the CCP. Should the clearing members vote against continued CCP support, we would expect the resolution of the CCP would be commenced.

D. Partial Tear-Ups (PTUs) & Variation Margin Gains Haircutting (VMGH)

The Consultation recommends resolution authorities evaluate the use of PTUs and VMGH from non-defaulting market participants when assessing available resources for default loss scenarios. Specifically, the proposal notes authorities should consider the governance processes and financial stability implications around the use of these tools.¹⁵ While we are broadly supportive of the resolution authority considering the governance process and financial stability implications around use of these tools, we believe the guidance should be more stringent on these matters.

¹² Consultation: Part I; Section 2.1.1

¹³ Consultation: Part I; Section 5.2.2

¹⁴ Additional and important details on this topic are included in the CCP White Paper.

¹⁵ Consultation: Part 1; Sections 2.1.3 and 2.1.4

Financial Stability Implications

The use of PTUs¹⁶ and VMGH could have a destabilizing impact on the financial system, as non-defaulting clearing members and end-users, in particular, are likely to liquidate trades in anticipation of such an adverse outcome.¹⁷ As this would put pressure on an already precarious market, utilizing these tools should be considered very carefully by resolution authorities.

Governance process

To mitigate the adverse financial stability implications of PTUs and VMGH, we recommend the requirement for oversight by, and explicit approval from, the resolution authority and/or the relevant competent authority before the tools are applied, even in recovery. In addition, their use should be subject to limits in scope and time whether used in recovery or resolution. For example, PTUs should be applied only to a limited number of transactions that are too illiquid to close (such as when there is no price the market is willing to bear) and VMGH must be limited in amount and time (e.g., no more than a day).

Furthermore, tools like PTUs and VMGH should be considered “financing” resources (as discussed above), whether they are used during recovery or resolution, and compensation should be provided to clearing members and end-users for losses incurred through their use.

E. Initial Margin Haircutting (“IMH”)

In assessing gaps in resources, the Consultation states that resolution authorities should consider write down/bail-in powers; specifically: “whether non-bankruptcy remote initial margin would be available and, if so, would the resolution authority have the power to write it down.”¹⁸

We strongly oppose the inclusion of any provision which results in the use or potential for use of IMH. Initial margin is contributed by clearing members and end-users to collateralize their own positions and is not meant to be available for loss mutualization. IMH, or allowing the CCP to use a portion of the cash margin of non-defaulting participants as a mutualized resource to cover CCP losses, should be prohibited for use in either recovery or resolution. IMH could create ex ante liquidity constraints for CCPs as market participants may prefer posting non-cash collateral to avoid the risk of IMH.

F. Non-Default Losses

The Consultation recommends resolution authorities evaluate the availability of several tools for non-default loss scenarios, including the use of CCP equity and the allocation of losses to clearing members.¹⁹ When suggesting allocation of losses to clearing members, the Consultation highlights that authorities should analyze the potential impact on clearing members and end-users and possible financial stability concerns.

¹⁶ CCPs should not be permitted to forcibly allocate positions to non-defaulting clearing participants as they may not have the risk appetite or ability to risk-manage such positions.

¹⁷ An asset manager’s fiduciary obligation to its clients could significantly influence its decision on if and when to liquidate positions when a CCP encounters distress.

¹⁸ Consultation: Part I; Section 5.3 (iii)

¹⁹ Consultation: Part I; Section 2.2.2 and 2.2.3

We believe that it is inappropriate for clearing members or end-users to bear non-default losses in recovery or resolution since they are not involved in or responsible for the choices that led to them. CCPs are responsible for managing substantial amounts of collateral daily and are consequently vulnerable to cyber-threats and attacks that could lead to significant monetary loss that may not be recoverable. CCPs could also incur losses resulting from operational failures, fraud, theft or malicious acts of employees or external actors, and credit deterioration of investments.

Therefore, CCP rulebooks should clearly state that CCPs bear full responsibility for non-default losses.²⁰ Regulators should require CCPs to measure, monitor, and hold enough capital against non-default losses to ensure that such losses do not disrupt the CCP's ability to perform its obligations.

IV. Treatment of CCP equity in resolution

With regard to Part II of the Consultation, we appreciate that it recognizes moral hazard concerns from equity surviving the resolution process and outlines mechanisms for adjusting CCP equity exposure to ensure that is fully loss absorbing in compliance with the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB Key Attributes) and the FSB Guidance on Central Counterparty Resolution and Resolution Planning published in July 2017 (FSB 2017 Guidance). We support the FSB's intent and agree to a large extent with the mechanisms and considerations listed.

However, while we acknowledge the need for flexibility in the guidance to allow implementation across jurisdictions, we believe the guidance is not sufficiently prescriptive on the treatment of equity. As such, we have summarized below specific areas of concern where increased focus and more prescriptive guidance from the FSB are warranted.

A. Assessing the treatment of CCP equity in resolution plans

The Consultation rightly acknowledges that there may be a moral hazard implication of equity surviving a resolution process and considers the need of resolution authorities to work with supervisors to revise loss allocation rules. We agree that the relevant home authorities should address any existing challenges relating to CCP equity fully bearing losses in resolution. We are supportive of authorities requiring CCPs to modify structures in a manner that would subordinate shareholders to other creditors or define the point where equity absorbs losses in legally enforceable terms.

Notwithstanding these admonitions, there is an unfortunate and implicit acceptance²¹ that where jurisdictions do not incorporate the FSB's recommended changes, there may be local limitations (which may include lack of legal authority) on CCP equity fully bearing losses. This is counter to the FSB Key Attributes that state that in resolution CCP equity should absorb losses first, that CCP equity should be fully loss-absorbing, and that resolution authorities should have powers to write down (fully or partially) CCP equity.

²⁰ We acknowledge that there may be specific scenarios related to custodial and settlement bank risk in which CCPs disclaim responsibility for potential losses within their rules. In these instances, we would expect that the enforceability of these rules would remain subject to a standard of care in the CCP managing such risk.

²¹ Consultation: Part II; Section 8.

We disagree with an acceptance that local limitations should compromise such foundational resolution concepts and believe that the guidance should not allow such exceptions, as with such exceptions we run the risk that they may become the norm. Rather than accept legal limitations with existing frameworks, we believe it is critical for the guidance to state that resolution authorities should require CCPs to modify rules and implement structures, in a manner described below, that would enable compliance with the FSB Key Attributes.

We believe that consideration should be given to modifying contractual loss allocation arrangements as proposed in the guidance.²² Specifically and in line with our recommendation in the CCP White Paper, the CCP's residual capital (funds that are held to support the CCP's day-to-day operations, outside the default waterfall) should be applied in recovery to absorb outstanding losses. Exposing residual equity as part of the default waterfall in recovery and requiring equity to be fully available for non-default losses would help negate concerns around legal limitations on CCP equity fully bearing losses.

In addition, exposing residual equity in recovery would remove the potential for shareholders to raise "no creditor worse off in liquidation" (NCWOL) claims. Given that CCP equity would be subject to similar losses in both recovery and liquidation, CCP shareholders would have no grounds to raise NCWOL claims, which would further support compliance with the resolution objectives of writing down CCP equity. It is worth noting that the construct of NCWOL was developed in the context of bank resolution to protect similarly situated creditors. It was not intended to extend protection to equity holders and we believe such an extension of protection is an unintended consequence of implementing loss allocation structures that shield CCP equity and avoid the CCP's insolvency at the expense of non-defaulting market participants who are not CCP shareholders.

B. Mechanisms for Adjusting Treatment of CCP Equity

Minimum Regulatory Requirements

In considering the various options that can be used in exposing CCP equity to losses in resolution,²³ the guidance raises concerns that extinguishing CCP equity can result in capital falling below minimum regulatory requirements and suggests that the resolution authorities would need to account for this in their planning. We agree that once the CCP's residual capital is applied in recovery, it would need to replenish this capital immediately to meet minimum regulatory capital requirements in order to continue to operate outside of resolution. To do so, it would have to source these resources from its shareholders, who earn a return from the CCP's continued business operations. However, to plan for an eventuality that the CCP does not replenish its minimum regulatory capital and avoid the resolution authorities' need to manage the shortfall, we recommend that the regulators require CCPs to set aside pre-funded resources for resolution on an ex-ante basis that can be used to ensure minimum capitalization at all times.

One option in the case of for-profit CCPs in particular would be for CCPs to issue long-term debt securities to unaffiliated institutional investors. As we suggest in the prior section, should the resolution authority require use of residual capital as the last step in recovery – and thereby potentially leave the CCP undercapitalized - authorities would be

²² Consultation: Part II; Section 7(i).

²³ Consultation Part II; Section 7(i) and 7(ii).

able to “bail in” the prefunded securities and convert them to equity to ensure continuity of clearing, restore a CCP’s access to resources, and even potentially effect a change in control of the resolved CCP. While the guidance currently acknowledges that conversion of debt instruments to equity could be one way of adjusting treatment of equity,²⁴ to ensure this mechanism is a viable tool, there should be an explicit requirement for CCPs to issue debt.

In this context, we note our concern that the guidance overly relies upon resolution cash calls from non-defaulting members for both loss allocation and recapitalization. The guidance rightly recognizes the performance risk associated with unfunded and uncommitted resources²⁵ and notes the need to differentiate and discount resources based on the nature of resources and confidence that they are likely to be available considering the impact of concurrent cash calls by several CCPs. We believe that these considerations, if not addressed could impact the credibility of the resolution plan and recapitalization strategy.

As noted above, in order to limit the pro-cyclical effect of assessments, enable members to measure and manage their exposures, and reduce the likelihood of systemic risk or a liquidity crunch, cash calls should be limited to a maximum of a clearing member’s default fund contribution (1xDFC) immediately before the default. To the extent that additional resources are required, we believe that there should be a ballot mechanism during the recovery phase to determine if clearing members are willing to support the CCP. Members should be incentivized to support the CCP by receiving compensation (see section on Compensation below) in exchange for the additional assessment.

Compensation

The guidance currently acknowledges that a mechanism to adjust treatment of equity could be the compensation of clearing members through the issuance of new shares in exchange for them bearing more losses than under CCP rules.²⁶ However, the effectiveness of this mechanism may be impacted by the fact that several CCP rulebooks have provisions that shield residual CCP capital.

As we note in the CCP White Paper, we believe that compensation should be provided to clearing members and end-users for all losses incurred as a result of post-ballot default fund assessments, VMGH, or PTUs, whether during recovery or in resolution. Such compensation should be in predefined instruments determined ex-ante that are equity-like to ensure that they would not render the CCP insolvent during the recovery process and should place the claims of participants ahead of the claims of CCP shareholders thereby facilitating the write down of equity.

It is important to remember that by contributing financing resources, non-defaulting clearing participants and their shareholders are backstopping publicly-owned CCPs that they neither own nor control. Therefore, providing compensation for such contributions would be consistent with corporate finance principles and would serve as an incentive for clearing members and end-users to ensure continuity of the clearing service.

²⁴ Consultation: Part II; Section 7(iv).

²⁵ Consultation; Part I; Section 2.1.1(iii).

²⁶ Consultation: Part II; Section 7(iv).

C. Implementing Policy for the Treatment of CCP Equity in Resolution

Incentives of Stakeholders

In evaluating the considerations for impacting CCP equity, the guidance focuses on incentives for stakeholders to support recovery and avoid resolution.²⁷ We agree it is important to ensure there are proper incentives for stakeholders to support recovery, and providing compensation as described above is a key element to ensuring participants are incentivized accordingly. Robust IM models and conservative default fund sizing ensures that clearing members are incentivized to maintain their own appropriate risk management standards.

Clearing members are subject to sizable default fund contributions and assessments while many clearing participants' largest trade exposures are to CCPs, and these participants would face significant losses from the unwinding of these sizeable positions. The financial exposure associated with a potentially unwinding is a powerful incentive for participants to support the recovery and continuity of CCPs. We therefore strongly believe that as suggested in the guidance, greater focus and more detailed guidance should instead be provided to evaluate and ensure that CCP management and shareholders are incentivized to appropriately balance risk mitigation and returns.²⁸

Incentives of CCP management and shareholders

As we note in the introduction, most of the systemically important CCPs are for-profit institutions. These firms currently contribute a limited amount of capital to address default and non-default losses. As such, they lack sufficient skin-in-the-game (SITG) to ensure alignment of incentives. While CPMI-IOSCO in the guidance it published in 2017 requires CCPs to contribute capital as part of the waterfall, it does not specify the amount of capital that should be contributed. Thus, it is not surprising that many CCPs still have insignificant capital levels within the default waterfall.

We believe that further regulatory work and more detailed guidance is required to develop a meaningful capital framework that addresses all aspects of both default and non-default losses to be borne by CCPs.

As we note in the CCP White Paper, CCPs must be required to maintain a material amount of SITG across two equally sized tranches in the waterfall. Placing SITG in two tranches in the waterfall provides incentives for a CCP to maintain robust IM calibration (so as to protect the junior tranche) and a conservative default fund (to protect the senior tranche). Furthermore, so CCP shareholders are incentivized to ensure the possibility of resolution is remote, as we noted in the section on Treatment of Equity, a CCP's residual capital (funds that are held to support the CCP's day-to-day operations, outside the default waterfall) should be applied in recovery to absorb outstanding losses.

We appreciate the FSB's efforts in issuing the Consultation and considering our comments and look forward to discussing our feedback. If we may provide further information or answer any specific questions, please do not hesitate to contact us.

Sincerely,

²⁷ Consultation; Part II; Section 8(ii).

²⁸ Consultation: Part II; Section 8.(i).

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