

MEMO# 32627

July 22, 2020

FSB Consultation on CCP Resolution: Draft ICI Global Letter - Member Input Requested by Tuesday 28 July

[32627]

July 22, 2020 TO: Derivatives Markets Advisory Committee
Global Advocacy Coordination Advisory Committee
ICI Global Regulated Funds Committee
ICI Global Trading & Markets Committee RE: FSB Consultation on CCP Resolution: Draft ICI
Global Letter - Member Input Requested by Tuesday 28 July

As previously advised,[\[1\]](#) on 4 May 2020 the Financial Stability Board (FSB) published a consultative document (“the consultation”) on proposed guidance for financial resources to support central counterparty (CCP) resolution and the treatment of CCP equity in resolution.[\[2\]](#) ICI Global’s draft response is attached, on which we are seeking member comments by Tuesday 28 July. Below is a summary of our draft response and the areas we are seeking additional member input on.

Summary of ICI Global’s draft response

We are supportive of the FSB’s work to develop guidance on CCP resolution and the financial resources available to support a resolution proceeding as we consider that if implemented correctly this could reduce uncertainty in the event of a CCP’s failure and assure market participants that they will receive fair treatment from resolution authorities.

We are also supportive of the FSB’s proposed five-step process for assessing the adequacy of financial resources and tools available to support the resolution of a CCP, but have recommended the following changes to enable regulated funds, as customers of CCPs, to receive fair treatment during a CCP’s resolution:

- **Transparency:** at a minimum, the FSB should encourage authorities to communicate to clearing participants (CCP members and customers) the tools and strategies they would plan to use to resolve a failed CCP;
- **Certainty and consistency:** the FSB should establish 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;
- **Fair Treatment:** the FSB should support 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 who are users of the CCP that play no meaningful role in CCP risk management and have not contributed to the CCP's distress;

- Aligned incentives: the FSB should not support the use of resolution tools such as variation margin gains haircutting and contract tear ups that may discouraging voluntary clearing, create moral hazard by incentivising CCPs and their clearing members to take excessive risks, or destabilise markets by incentivising clearing members and CCP customers to liquidate trades in anticipation of adverse outcomes in times of stress;

Areas where we are requesting additional member input

To enable us to finalise ICI Global's draft response, we are seeking member input in the following areas:

Step 1: Identifying hypothetical default and non-default loss scenarios that may lead to resolution (consultation question 1 and 2)

We recommend that the FSB defines the threshold for the commencement of resolution proceeding 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 default fund commitments).

Member input: Do you agree with this and support an internationally consistent approach?

We agree with the FSB that the analysis of loss scenarios undertaken by authorities should include losses resulting from: (i) the hypothetical scenarios outlined by the FSB in the consultation;[\[3\]](#) (ii) the crystallisation of custody, investment, legal and operational activity, including in accordance with CPMI-IOSCO guidance;[\[4\]](#) and (iii) unallocated losses arising from the materialisation of general business risk. We urge the FSB to recommend that the evaluation undertaken by authorities extends beyond just a scenario analysis and requires authorities to develop and test playbooks and simulation resolutions, including across different authorities within crisis management groups.

Member input: Can you identify any other default or non-default loss scenarios or risks beyond those in section 1.1 and 1.2 in the consultation (page 4-6)? Do you agree that authorities should develop and test playbooks and simulate resolutions as part of resolution planning?

Step 2: Conducting a qualitative and quantitative evaluation of existing resources and tools available in resolution (consultation question 3 and 4)

We recommend that the FSB includes the potential for adverse effects on customers that may render tools and resources unusable or unavailable for resolution, in the list of key points to be considered by authorities when evaluating existing tools and resources.

Member input: Do you agree with including the potential for adverse effects on customers in the evaluation of existing CCP tools and resources by authorities?

We recommend that the FSB encourages authorities to include the details of the implications from different factors on the availability of potential loss absorbing resources, specific types of products cleared and CCP ownership structures, when making public the full text of CCP resolution plans or a summary of the material portions of each plan.

Member Input: Do you agree with including the proposal for authorities to make public their assessment of the implications for the availability of various potential loss absorbing resources from factors including the specific types of products cleared and CCP ownership structures?

Tools for Default Loss Scenarios

We strongly use the FSB to discourage the use of variation margin gains haircutting (VMGH) and contract tear ups (CTUs) on the basis that they pose a serious risk to non-defaulting customers of clearing members and risks undesirable ramifications including:

- discouraging voluntary clearing – by introducing risks that do not exist in uncleared derivatives products and that they cannot monitor or control;[\[5\]](#)
- encouraging questionable risk management practices at CCPs – incentivising 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; and
- destabilising market effects – incentivising clearing members and CCP customers to liquidate trades in anticipation of adverse outcomes, increasing pressure on an already destabilised market in times of stress.

Member input: Do you agree with the discussion of VMGH and CTUs above and the ramifications of their use listed above?

Tools for Non-default Loss Scenarios

We urge the FSB to expressly rule out the use of customer assets to cover non-default losses as these losses should be borne entirely by the CCP and its shareholders, given that they result directly from business decisions of the CCP's management.

Member input: Do you agree that customer assets should not cover non-default losses? The FSB recommends that authorities evaluate how cash calls can be “measurable, manageable and predictable” but does not set out any explicit parameters such as caps. Should we include a discussion on cash calls in our response and if so what parameters or requirements should we suggest?

Step 3: Assessing potential resolution costs (consultation question 5 and 6)

We reiterate our position that FSB should discourage the use of tools – including VMGH and CTUs – which seize the assets of non-defaulting customers of clearing members. If, despite the FSB's guidance, authorities envisage using tools or other mechanisms to seize the assets of non-defaulting customers, then we urge the FSB to make clear that the “costs” of these tools or other mechanisms to seize the assets of non-defaulting customers, including compensation payable to non-defaulting customers, should be factored into the analysis of the ultimate costs which will need to be “recovered” before resolution proceedings have been completed.

Step 4: Comparing existing resources and tools to resolution costs and identifying any gaps (consultation questions 7-9)

We broadly agree with the key points identified by the FSB for authorities to consider when comparing the resolution costs assessed in Step 3, to the resources and tools analysed in Step 2 under the different resolution scenarios identified in Step 1. This comparison is to identify potential shortfalls or gaps that could cause resources to be inadequate to achieve the resolution objective.

We reiterate the merit in establishing through the FSB's guidance, an internationally consistent definition of the threshold for the commencement of resolution proceedings and urge the FSB to encourage authorities to consider the implications of using tools and resources on the customers of CCP members.

Member input: Do you agree that the FSB should encourage authorities to consider the implications of using tools and resources on the customers of CCP members?

Step 5: Evaluating the availability, costs and benefits of potential means of addressing any identified gaps (consultation questions 10-11)

We have set out below recommendations and concerns in respect of the FSB's proposals for writing down initial margin, and the alignment of incentives and governance to avoid moral hazard where tools and resources that seize customer assets are used.

Initial Margin Haircutting

We oppose the inclusion of any tools which would result in initial margin haircutting (IMH) of non-defaulting participants as this amounts to the use of a mutualised resource to cover CCP losses.

Member input: Do you agree that there are no circumstances where initial margin haircutting is acceptable? What other arguments should we use to oppose its use – will it create incentives to post non-cash collateral?

Alignment of incentives

We urge the FSB to consider carefully the incentives that its final guidance will create for all CCP constituencies, including customers, owners, managers, and clearing members. We reiterate our objection to ceasing customer assets to fund resolution and urge the FSB to incorporate into its guidance other options 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.

If the FSB is unwilling to rule out the use of customer assets to resolve a CCP, we set out that at a minimum, it should constrain the use of these assets to a tool of last resort that can be accessed only:

- after other tools have been exhausted;
- if approved and supervised by a resolution authority;
- if subject to robust and inclusive governance processes, including the involvement of

clearing members and customers;

- if subject to pre-determined caps;
- if used in a non-discriminatory and transparent manner; and
- if subject to appropriate customer compensation for incurred losses

Member input: Are you supportive of proposing, as a last resort measure, that tools which seize customer assets can be used and if so, which parameters or constraints should be imposed? Do you agree with the conditions proposed above?

Next Steps

Please provide your input on the questions above to me by Tuesday 28 July. ICI Global will file its final response with the FSB by the 31 July deadline.

Giles Swan
Director of Global Funds Policy
ICI Global

[Attachment](#)

endnotes

[1] See Memorandum No. 32597, RE: FSB Consultation on CCP Resolution: Member Input Requested by Tuesday 21 July, dated 13 July 2020, *available from* https://www.ici.org/my_ici/memorandum/memo32597

[2] Consultative document: Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution, Financial Stability Board, 4 May 2020, *available from* <https://www.fsb.org/wp-content/uploads/P020520.pdf>

[3] Section 1.1 and 1.2, Consultation

[4] CPMI-IOSCO Recovery of Financial Market Infrastructures Guidance, July 2017, *available from* <https://www.bis.org/cpmi/publ/d162.pdf>

[5] A regulated fund can, for example, use a third-party custodian (e.g. EU depositary) to remove the ability of a bilateral counterparty to seize its initial or variation margin in the absence of a default by the fund.