

MEMO# 32645

July 29, 2020

FSB Consultation on CCP Resolution: ICI Global Response

[32645]

July 29, 2020 TO: ICI Global Members
Derivatives Markets Advisory Committee
Global Advocacy Coordination Advisory Committee
ICI Global Regulated Funds Committee
ICI Global Trading & Markets Committee SUBJECTS: International/Global RE: FSB
Consultation on CCP Resolution: ICI Global Response

On 29 July 2020, ICI Global submitted its response to the Financial Stability Board's consultative document ("the consultation") on proposed guidance for financial resources to support central counterparty (CCP) resolution and the treatment of CCP equity in resolution.[\[1\]](#) The submitted response takes account of member input on the draft.[\[2\]](#)

Summary of ICI Global's submitted 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 the FSB's proposed guidance 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 – clearing members (CMs) and customers – the tools and strategies they 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, the resources of CMs that are committed to the CCP's recovery and, if applicable, credit facilities or capital injections that may be provided by a parent entity;
- **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, CMs and equity holders – rather than seizing

resources from non-defaulting customers (NDCs) who are users of the CCP that play no meaningful role in, or control over, CCP risk management and have not contributed to the CCP's distress; and

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

We consider that these recommendations 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.

Transparency

We suggest that authorities should, at a minimum, communicate: the following to clearing participants:

- a definition of when a CCP resolution begins;
- the likely steps that a resolution authority would take to resolve a CCP; and
- the resources the CCP expects to finance each step of resolution, including the CCP's own resources, committed resources of CMs and, if applicable, credit facilities or capital injections that may be provided by a parent entity.

We recommend that the FSB develops guidance to support the standardisation of disclosures from CCPs – to support authorities in assessing recovery tools and resources and to enable market participants to obtain a comprehensive picture of the cleared market. Furthermore, that the FSB should consider how material changes can be communicated effectively to market participants, including CCP customers, between annual resolution plan publications.

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, 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) and any non-prefunded resources, such as a capital injection from a parent entity.

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; (ii) the crystallisation of custody, investment, legal and operational activity, including in accordance with CPMI-IOSCO guidance; 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 also requires authorities to develop and test playbooks, simulation resolutions and undertake reverse stress tests, including across crisis management groups (CMG.)

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.

We recommend that the FSB encourages authorities to set out the implications arising from the specific types of products cleared by the CCP and from its ownership structures, on the availability of potential loss absorbing resources. We suggest that this could include, for instance, the “contribution” that each product type makes to the estimated overall resolution costs of the CCP and the implications of the CCP’s ownership structure (e.g, mutualised, for profit etc.) on the relative value of equity and the default fund compared to average levels across other CCPs.

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;
- 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.

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.

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

We reiterate our prior 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, including compensation payable to NDCs, should be factored into the analysis of the ultimate costs that will need to be “recovered” when replenishing financial resources necessary to return the CCP to a viable financial position.

We support the FSB’s proposed approach that authorities should quantify the costs resulting from custody, investment, legal and operational losses, in accordance with CPMI-IOSCO guidance and unallocated losses arising from the materialisation of general business risk (subject to discouraging the use of tools that seize the assets of NDCs.) We urge the FSB to recommend that authorities also consider concentrations of exposures, for instance

the use by a CCP of a single or limited number of custodians to safekeep margin. Furthermore, 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 CMG.

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.

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

We provide feedback on 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 may have significant unintended consequences, including incentivising CCP customers to liquidate trades in anticipation of adverse outcomes.

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, however, is unwilling to rule out the use of NDC assets to resolve a CCP, we set out that at a minimum, that the use of these assets should be last resort and only for DLs (under no circumstances should these tools be used for recovery or for NDLs in resolution). Tools that seize NDC assets should only be accessed after other tools have been exhausted and subject to:

- approval and supervision by a resolution authority;
- robust and inclusive governance processes, including the involvement of CMs and

customers;

- pre-determined caps;
- use in a non-discriminatory and transparent manner;
- applied on a gross rather than net basis; and
- appropriate NDC compensation for incurred losses.

We note that regardless of the tools used, resolution proceedings should be swift and transparent as regulated funds need to fairly value the margin they have posted with a CCP that is undergoing resolution to calculate net asset value and fund performance and also to ensure that regulatory limits, including on illiquid assets, are respected.

Next Steps

The FSB will use the input it has received in response to the consultation to develop its guidance on for financial resources to support central counterparty (CCP) resolution and the treatment of CCP equity in resolution

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] See Memorandum No. 33627, RE: FSB Consultation on CCP Resolution: Draft ICI Global Letter - Member Input Requested by Tuesday 28 July, dated 22 July 2020, *available from* <https://www.iciglobal.org/iciglobal/pubs/memos/ci.memo32627.global>