

COMMENT LETTER

September 7, 2018

ICI Global Files Comment Letter on Incentives to Centrally Clear OTC Derivatives (pdf)

07 September 2018 Submitted electronically to fsb@fsb.org Secretariat of the Financial Stability Board c/o Bank for International Settlements CH-4002 Basel, Switzerland Re: Incentives to Centrally Clear Over-the-Counter Derivatives Dear Sir or Madam: ICI Global¹ appreciates the opportunity to comment on the consultation by the Financial Stability Board and other standard-setting bodies (SSBs) on incentives to centrally clear over-the-counter (OTC) derivatives.² We commend the SSBs' efforts to evaluate how the interaction of reforms adopted in the wake of the global financial crisis affects market participants' incentives to centrally clear OTC derivatives. We have supported the G-20 commitments to reform the derivatives markets, including clearing standardized derivatives contracts, which can mitigate counterparty credit risk and reduce the likelihood that systemic risk will build undetected by regulators. This letter focuses on question 9 of the Consultation, which requests input on potential policy adjustments that should be considered to enhance incentives for central clearing of OTC derivatives. Specifically, we urge the SSBs to adjust their guidance on the resolution of a central counterparty (CCP) to ensure that customers, such as regulated funds, are treated fairly if a CCP fails. The Consultation acknowledges that the design of CCP resolution plans, which incorporate 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\$29.7 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 Basel Committee on Banking Supervision, Committee on Payments and Market Infrastructures, Financial Stability Board, and the International Organization of Securities Commissions, Incentives to centrally clear over-the counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms (7 August 2018) (Consultation), available at <http://www.fsb.org/wp-content/uploads/P070818.pdf>. Secretariate of the Financial Stability Board 7 September 2018 Page 2 of 5 elements of SSB guidance, might provide a disincentive to clear.³ As we explain in Section I, this disincentive arises from the possibility that assets of non-defaulting customers could be appropriated during a resolution proceeding. In Section II, we recommend that the SSBs revise their guidance on CCP resolution to improve customer protections and promote increased clearing of OTC derivatives. I. Regulated Funds Support Central Clearing for OTC Derivatives, but Should Not Risk Having Their Assets Seized to Bail-Out A Failing CCP Our

members—investment companies that are registered under the Investment Company Act of 1940 and other regulated funds in jurisdictions around the world (collectively, “regulated funds”)⁴—use derivatives in a variety of ways. 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 example, hedging positions, securitizing cash that a regulated fund cannot immediately invest in direct security holdings, managing a regulated fund’s cash positions more generally, adjusting the duration of a regulated fund’s portfolio, and managing a regulated fund’s portfolio in accordance with the investment objectives stated in a regulated fund’s prospectus. ICI Global members, as market participants managing portfolios on behalf of millions of investors, generally support the goal of promoting efficient and transparent derivatives markets, including centralized clearing for standardized derivatives products. The increased use of cleared OTC derivatives means, however, that regulators must provide effective oversight of CCPs and ensure that an appropriate regulatory framework exists to govern CCPs and to resolve or wind down a failed CCP. Certain SSBs have sought to provide such a framework through guidance on the resilience, recovery, and resolution of CCPs.⁵ In general, this guidance provides CCPs and their regulators flexibility concerning the time and which a CCP’s recovery or resolution plan is initiated and the 3 See Consultation at 89 (calling for more research into the design of CCP recovery and resolution plans and the incentives or disincentives that they might create). 4 For purposes of this letter, the term “regulated fund” refers to any fund that is organized or formed under the laws of a nation, is authorized for public sale in the country in which it is organized 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 organization, 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. 5 See Financial Stability Board, Guidance on Central Counterparty Resolution and Recovery Planning, July 5, 2017, available at <http://www.fsb.org/wp-content/uploads/P050717-1.pdf>; Committee on Payments and Market Infrastructures and International Organization of Securities Commissions, Resilience of central counterparties (CCPs): Further guidance on the PFMI, July 2017, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD568.pdf>. Secretariate of the Financial Stability Board 7 September 2018 Page 3 of 5 measures and resources to be used in these plans. Although ICI Global supports these efforts to develop plans for the orderly recovery or resolution of a failed CCP, we believe that aspects of this guidance provide a disincentive to centrally clear OTC derivatives transactions by permitting the use of non-defaulting customer assets—i.e., through margin haircuts and contract tear-ups—to resolve a CCP.⁶ Margin haircuts and contract tear-ups potentially discourage customers from centrally clearing OTC derivatives because these measures—which amount to a seizure of non-defaulting customer assets—introduce risks that do not exist in uncleared derivatives products and that the customer cannot monitor or control.⁷ Both of these resolution tools would allocate losses to parties that have not contributed to a CCP’s distress but that happen to have their assets available to the CCP when its risk management function fails. Regulated funds and other customers play no meaningful roles in the risk management process of a CCP and do not share in the profits of the CCP’s business. The only way that regulated funds can mitigate the risk of a CCP seizing their assets is to reduce their use of the CCP. II. Incorporating Greater Customer Protections into Guidance on CCP Recovery,

Resilience, and Resolution Would Encourage Greater Clearing of OTC Derivatives To enhance incentives to centrally clear OTC derivatives, we recommend that the SSBs revise existing guidance on CCP resilience, recovery, and resolution to provide greater protections to regulated funds and other clearing customers. Specifically, we recommend that the SSBs alter their existing guidance in the following four ways: (1) make clear when a CCP resolution begins; (2) recommend resolution strategies that allocate losses to entities that contribute to a CCP's distress or the failure of the CCP's risk management process; (3) clarify that non-defaulting customer assets are a resolution tool of last resort; and (4) increase the transparency of the tools and strategies that will be used to resolve a CCP. We address each recommendation below. First, although we recognize the desirability of giving resolution authorities the flexibility to intervene earlier if circumstances warrant, we believe that the SSBs should revise their guidance to

6 See e.g., Letter from Dan Waters, Managing Director, ICI Global, to Secretariat of the Financial Stability Board, dated March 13, 2017, available at <https://www.ici.org/pdf/30634a.pdf> (urging the FSB to adopt guidance on CCP resolution and resolution planning that protects assets of non-defaulting customers of clearing member); Letter from Dan Waters, Managing Director, ICI Global, to Secretariat of the Financial Stability Board, dated October 17, 2016, available at https://www.iciglobal.org/pdf/16_ici_g_fsb_ccp_resolution_ltr.pdf (advocating for CCP resolution planning strategies that protect the assets of non-defaulting customers of clearing members, including margin and positions); Letter from Dan Waters, Managing Director, ICI Global, to Olivier Guersent, Director-General, Directorate-General for Financial Stability, Financial Services and the Capital Markets Union, European Commission, dated October 26, 2015, available at <https://www.ici.org/pdf/29447.pdf> (urging the European Commission not to permit variation or initial margin haircutting as a tool for CCP recovery); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated August 8, 2011, available at <http://www.ici.org/pdf/25388.pdf> (suggesting the adoption of regulatory standards that protect cleared swaps customer collateral).

7 A US regulated fund, for example, must use a third-party custodian to remove the ability of a bilateral counterparty to seize its margin in the absence of a default by the fund. Secretariate of the Financial Stability Board 7 September 2018 Page 4 of 5 specify that a resolution proceeding commences no later than when a CCP has depleted its own resources and 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 guarantee fund deposits). At this stage, the CCP cannot continue to provide clearing services without external funding, and resolution authorities should step in to determine whether and how to best resolve the CCP. Second, the SSBs should recommend that resolution authorities adopt resolution strategies that allocate losses and provide for replenishment of financial resources by those market participants that caused or contributed to a CCP's failure or can control the amount of risk they bring to or allow in the CCP (as clearing members or owners). Strategies that would not involve seizing customer assets would include imposing losses on CCP owners, selling new equity in the CCP and using the proceeds to replenish its financial resources, and setting aside additional pre-funded resources for use in resolution beyond those already stipulated in the regulatory requirements for CCPs. Each of these options would ensure that the stakeholders that failed to manage adequately the risks of the CCP also bear the financial consequences of its failure. Third, the SSBs should revise their guidance to clarify that resolution authorities may access non-defaulting customer assets only in resolution and only as a last resort, after other tools have been exhausted. The methodology and process for seizing assets of non-defaulting customers should be fair, transparent, and subject to pre-determined caps, and these customers should be fully compensated for their

loss. The SSBs also should recommend limiting any use of non-defaulting 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 and 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 incentivized to plan to address risks that could lead to these losses. Fourth, guidance should, as much as possible, encourage national regulators and resolution authorities to be transparent about the tools and strategies they will use to resolve a failed CCP. We recognize the importance of providing resolution authorities adequate flexibility to respond to unanticipated circumstances, but this flexibility should not be limitless. Rather, regulators should find a balance of transparency and flexibility that: (1) provides all market participants with guidance concerning the steps that would be taken to resolve a CCP; and (2) affords resolution authorities flexibility to deviate from a resolution plan if doing so would improve substantially the outcome of the resolution proceeding. Market participants that understand a clear plan exists to resolve a failing CCP likely will not panic upon activation of the plan, at least if they have confidence the plan will be followed. Instead, their response should be measured and proportionate to the risk 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. * * * * * Secretariate of the Financial Stability Board 7 September 2018 Page 5 of 5 We appreciate the opportunity to provide input on the Consultation. If you have any questions on our letter, please feel free to contact the undersigned, Jennifer Choi, Chief Counsel, ICI Global, at (202) 326-5876 or jennifer.choi@iciglobal.org, or George Gilbert, Assistant General Counsel, ICI, at (202) 326-5810 or george.gilbert@ici.org. Sincerely, /s/ Dan Waters Dan Waters Managing Director ICI Global