



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

Submitted via email to: fsb@fsb.org

1 February 2019

RE: Financial Stability Board Discussion Paper: Resources to support CCP resolution and the treatment of CCP equity in resolution

Dear Sir, dear Madam,

We commend regulators' efforts to make the financial system safer in the wake of the global financial crisis (GFC). Today the financial system is more resilient; additional capital requirements, together with the shift to centrally clear over the counter (OTC) derivatives should help insulate the financial system from shocks of the like witnessed 10 years ago during the GFC. Market participants have worked alongside regulators to deliver clearing access, increasingly competitive services and products contributing to the success of the reform efforts to date.

BlackRock is supportive of central clearing. The reduction in bilateral counterparty credit risk, increased market transparency, together with the improved efficiency in trade execution outweigh the significant operational costs incurred by market participants and end-investors to comply with clearing mandates. In fact, a number of market participants who are not subject to clearing mandates, including end-investors, do decide to clear voluntarily. This indicates that clearing mandates may not always be necessary and that these firms see advantages in clearing.

While much work has been done already to develop central clearing and by so doing underpin global financial stability, more work still needs to be done to improve its operational efficiency, incentivize a wider range of participants and, importantly, to protect the end-investor. The importance of continued regulatory focus was emphasized by the large mutualized loss experienced in the Nordic power markets in September 2018, with two-thirds of a central counterparty clearing house's (CCP) default fund consumed by one single clearing member default. While the CCP proved resilient, the loss allocation defied expectations and should challenge assumptions. Extreme market moves happen at unexpected intervals and in unexpected places.

The key differentiator to a CCP's risk profile is the cascading layers of financial protection that they maintain, generally referred to as a "waterfall". Despite deep and widely held concerns in the asset owner and asset manager community, many CCPs are able to use end-investor funds after they have run through their default management waterfalls and before they have exhausted their own equity. With such structures, it is even more critical for CCPs to be sufficiently resilient to fully achieve the risk reducing goals of central clearing.

End-investors have a direct interest in ensuring an effective and fair regime for recovery and resolution of CCPs without resorting to a taxpayer bailout. An effective regime for central clearing can strengthen investor confidence underpinning financial stability. A loss of confidence leads to reduced investment and could cause investor flight, which can exacerbate a crisis. We therefore welcome the opportunity to provide comments to the Financial Stability Board (FSB) Discussion Paper on the resources to support CCP resolution and the treatment of CCP equity in resolution from the perspective of the end-investor.

CCP resolution

BlackRock is aligned with the goal of avoiding the use of taxpayer funds to resolve a CCP. The end-investor who is mandated to centrally clear, or who decides to voluntarily clear, is often the same taxpayer who authorities are seeking to protect.

Overall, we believe the current “line in the sand” into resolution needs to be redrawn. In our view, the threshold into resolution should occur only when all voluntary sources of capital have been exhausted. Allowing the owners of the market infrastructure to force the costs of providing critical services onto the market, while preserving their (the owners’) ability to capture future profits is simply bad economics. We believe in the alignment of risk with return and this approach breaks that alignment.

It could be assumed that if continuity of critical services is important to the market, the market will find a way to fund continued operations. This view is underpinned by the fact that CCPs are extremely profitable businesses and are likely to continue generating returns for owners. CCPs are largely monopoly providers of a mandated service.

Comments in response to the Discussion Paper

All recovery and resolution tools should be analyzed in detail ex-ante, taking into account the respective costs and benefits of their application to the different actors comprising the financial ecosystem. For example, spreading CCP losses to real economy end-investors / taxpayers at the time of financial crisis is likely to exacerbate financial instability and erode confidence in the financial system. The five-step process described in the first part of the discussion paper on financial resources for CCP resolution forms a helpful basis for the analysis of the appropriateness of the financial resources of a CCP in light of its recovery and resolution plans

In our view, **the resolution authority should be the sole entity responsible for overseeing any losses to market participants in recovery and resolution**. A CCP-led recovery should be limited to private sources of voluntary capital. Depending on market conditions a resolution authority may need to step in to administer the allocation of losses using the available private sources of capital. The latest point at which a resolution authority must step in is when private sources of capital are depleted, and no further providers of capital are willing to invest in its continued operation. We firmly believe this is the point, if not sooner, where the resolution authority must take control.

The end-investor is ultimately committing the “real money” (i.e. their positions and margin). This means that all resolution tools could well have an impact on the taxpayer to a greater or lesser extent. Some tools, such as **variation margin gains haircutting (VMGH) is potentially destabilizing in times of market stress and has a particularly crude impact on end-investors by seizing their profit in a potentially uncontrolled way**. Loss allocation to market participants (outside of the pre-agreed funded default fund and assessments) also subsidizes the returns for CCP owners. In the event of CCP failure, end-users who anticipate this mechanism will rush to the exits to avoid the loss allocation.

VMGH, where it exists in CCP rulebooks, should therefore be a tool reserved **exclusively for controlled use by the resolution authorities**. This would ensure that losses would be allocated fairly, while ensuring that the owners of the business whose failure led to the losses are appropriately penalized. We also recommend **loss allocation tools that are embedded in CCP rulebooks should be removed or be subject to caps and be accompanied by a reimbursement requirement from a reconstituted CCP**.

We welcome that initial margin haircutting (IMH) is not explicitly mentioned in the discussion paper (other than in under bail-in in a slightly different context). IMH takes margin paid in by end-investors and takes a portion of it to cover losses caused by a clearing member default. Were IMH to be applied in a period of market stress, end-investors –who fear they will be subject to such profit/property seizure –will seek to rapidly close out positions, which is potentially destabilizing for markets. Further, some end-investors may voluntarily default by not meeting margin calls, preferring to lose their positions, rather than continue to pay margin that is subject to haircutting. Additionally, if IMH is permitted in some jurisdictions, it could drive clearing participants to clear only through CCPs in jurisdictions that either prohibit IMH or require initial margin to be held in a bankruptcy remote manner (so it is not subject to a haircut).

We also welcome that forced allocation is not explicitly mentioned. This is something that should be used sparingly and only where a meaningful market failure in a particular product is evident. Unlike partial tear-ups (PTUs), whereby clearing participants would 'lose' their existing positions, forced allocation would require clearing members to take on positions they may not be suited to risk manage in extreme market conditions (e.g., positions in products that such clearing participants intentionally do not transact), and could therefore have a negative impact on financial stability.

We are insistent that "allocation of losses to participants" should not generally be viewed as a tool for addressing non-default losses (NDLs). In our view, these losses should be the sole responsibility of the CCP. If they have a big loss they can't cover, let them sell the business to someone else who can operate it effectively. This type of loss allocation is even more egregious than default loss allocation under the rulebook.

Finally, **default auctions can be designed to incentivize participation, robust bidding, provide an efficient means for the CCP to return to a matched book and to allocate losses based on actual bids made by market participants.** Auctions also give members and end-users an opportunity to participate in default management and protect themselves against the use of recovery tools that they may view as unfavorable or undesirable, such as VMGH or tear-up. We would welcome global standard setters looking into the auction process to establish global principles as to how these should be organized, and with which level of participation given there is a high degree of inconsistency in this area across CCPs.

Conclusion

Resolution is the orderly wind down of the CCP. If recovery cannot be achieved, a CCP must be wound down, so resolution must begin when all sources of voluntary private capital are exhausted. The presumption that the continuity of all services in all CCPs is preferable to resolution is flawed since maintaining a CCP at all costs will not always be in the best interest of the financial system or the end-investor / taxpayer.

Compulsory loss allocation has not been removed from resolution plans. There is scant evidence of any differentiation between CCPs that should be allowed to fail and those that may require extraordinary support measures. Resolution frameworks should remove compulsory loss allocation, particularly for CCPs that are not systemically important.

BlackRock strongly believes that a resolution plan that focuses on a rapid and complete wind down of the failing CCP's positions, along with a timely and orderly repayment of margin monies is preferable to a recovery plan that uses end-investors' margin to extend the state of a failed or failing CCP. The wind down process within which no creditor is worse off (NCWO) should be one area, on which international consistency is sought.

CCP resolution plans could contain a prefunded re-capitalization fund if authorities believe it would be prudent to re-start the services of the CCP in a timely manner. Under a new management structure and fully re-capitalized default fund, there is a higher probability that market participants will return to use the new CCP facility relative to one that has been recovered with participants experiencing loss of margin.

We welcome further discussion on any of the points that we have raised.

Yours sincerely,

Eileen Kiely

Managing Director, Risk and Quantitative Analysis Group

Stephen Fisher

Managing Director, Global Public Policy Group