Response to Discussion Note on Essential Aspects of CCP Resolution Planning

To: Financial Stability Board

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Dear Sir/Madam,

ABN AMRO Clearing Bank N.V. (AACB)[1] welcomes the Discussion Note on Essential Aspects of CCP Resolution Planning recently published by the Financial Stability Board (FSB). AACB is strongly supportive of developing an appropriate global recovery and resolution framework to address systemic risk in the event of failure of a central counterparty (CCP). We broadly agree with the joint industry response of the Futures Industry Association (FIA), the Institute of International Finance (IIF), the International Swaps and Derivatives Association (ISDA), The Clearing House (TCH), and the Global Financial Markets Association (GMFI). At the same time, AACB considers it prudent to specifically underline the differences between derivatives cleared by a CCP that are either traded on an exchange or trading venue (ETD) and bilateral OTC derivative contracts (OTC). AACB specifically seeks to address the possible unintended consequences of variation margin gains haircutting (VMGH).

Introduction

Since the financial crisis, central clearing of financial instruments is considered as the *panacea* for addressing systemic and counterparty risk. As part of the Principles for Financial Market Infrastructure (PFMI), a range of measures have been implemented to mandate clearing for all standardised derivative products, encourage the use of CCPs, and draft global standards for the clearing and risk management of derivative trading. The commencement of a range of clearing mandates for OTC derivatives and overall growth in the trading volumes for both exchange-traded and OTC derivatives underlines that clearing is a key element of managing business, counterparty and systemic risks. This development is indeed highlighting the importance of addressing the risk of failure of a CCP while seeking to minimise the effects on its participants and the global financial markets.

[1] AACB is one of the largest General Clearing Members (GCM) globally and provides clearing and related services on all major CCPs in Europe, the United States and Asia-Pacific. AACB solely acts as third party clearer and does not trade on its own account, nor against its clients; all our activities are for the risk and the account of underlying clients. The client base includes some of the world's largest market makers and liquidity providers in listed derivatives.

AACB therefore welcomes the proposals of the FSB to commence the discussion in order to provide the basis for global standards, as well as national and regional mandates for recovery and resolution measures in the unlikely event of a CCP default.

Despite the trend of growing standardisation, the global derivative markets are still extremely diverse in nature. First of all, a clear distinction should be drawn between derivatives cleared by a CCP that are either traded on an exchange or trading venue (ETD) and bilateral OTC derivative contracts (OTC). Despite that both products are cleared by a CCP, ETD and OTC derivatives have inherently different characteristics and risk profiles. In this context, AACB urges the need to recognise the diversity between products, levels of liquidity, type of market participants and trading methods in order to align appropriate recovery and resolution scenarios based on the predictability and possible success of preventing the failure of the CCP. This also means that mandatory recovery and resolution tools cannot be prescriptive; solutions that are adequate for one CCP may be completely inadequate for another CCP. This means that a "one-size-fits-all" solution is impossible.

AACB therefore believes that the basis for a successful recovery and resolution is tailored to the specific CCP based on a range of objective criteria and available tools. Applicable tools should be pre-defined and reflected in CCP rulebooks and mandates of resolution authorities (RA) in order to ensure predictability and transparency. AACB strongly believes that, when facing default losses, appropriate resolution and recovery scenarios and tools should at least be based on the following considerations:

- The type of CCP (horizontal model vs. vertical model; derivatives traded on exchange (ETD) and/or over-the-counter (OTC); derivatives and/or underlying instruments);
- Range of asset classes cleared;
- Market liquidity of instruments cleared;
- Number of clearing members and shareholders;
- Average duration of the contracts;
- Number of liquidity providers as trading participants on venue(s) cleared by the CCP;
- Market structure of the venue(s) cleared by the CCP (retail / professionals / eligible counterparties as trading participants);
- Level of interoperability between CCPs and interconnectedness of CCPs (i.e. through cross-margining);
- Legal holding structure;
- Applicable supervisory regime(s) and jurisdiction(s);
- Access to central bank liquidity.

Furthermore, AACB urges that the role and function of the GCM should not be underestimated when formulating legislation for CCP recovery & resolution. GCMs have already made significant contributions to existing measures to prevent CCP failure as part of the G20 commitments following global financial crisis in 2008. These include measures pursuant to European Markets and Infrastructure Regulation (EMIR) in the European Economic Area (EEA), as well as applicable SEC and CFTC rules based on to the Dodd-Frank Act.

In addition, Basel III (implemented as CRDIV/CRR in the EEA) mandates additional RWA charges for GCM exposure to CCPs and is currently imposing punitive capital requirements under the proposed Leverage Ratio requirements. All these measures, including the risk of additional (*ex ante*) contributions in case of CCP insolvency or failure, have an impact on the potential return on equity ("ROE") of a GCM. If this trend continues, one can think of scenarios where the business case of a GCM is no longer sustainable.

Besides tailored solutions based on the products and characteristics of the CCP, AACB's key principle for CCP recovery & resolution is that the burden should be shared between **all** participants in the chain. AACB firmly believes in a standardised mechanism to allocate default losses (e.g. for initial margin on certain CCPs) between exchanges, underlying (buy-side) clients and GCMs. This leads to a fair share of the losses between all participants as all participants benefit from central clearing and the guarantees provided by the GCM.

1. Recognise the key difference between ETD and OTC derivatives cleared by a CCP

AAC believes ETD and OTC derivatives have inherently different risks profiles and characteristics. AAC is therefore a strong proponent of recognising this in the applicable recovery and resolution scenarios and tools. The key differences between ETD and OTC derivatives are based on the following considerations:

In general:

- All ETDs are traded on an exchange or a multilateral trading facility (MTF)[2] whereas OTC derivatives are only traded bilaterally;
- ETDs are standardised ("plain vanilla") products whereas OTC derivatives are not;
- ETD markets are highly liquid and have market makers or liquidity providers as opposed to OTC derivatives markets;
- Often, economically equivalent or very similar ETD are traded on various trading venues globally, cleared by different CCPs;
- ETDs are primarily used as risk limiting transactions (futures/options);
- ETDs are always fully collateralised (initial and variation margin);
- ETD markets have transparent rules whereas OTC markets are opaque;
- Complex trades are seen as one single transaction through netting at position level, appropriate margining and quick close-out in case of default;
- ETDs are of limited duration whereas the majority of OTC-traded derivatives such as interest rate swaps are long-term contracts;
- The ETD markets served as blueprint for current cleared OTC derivative rules given its strong track record in times of stress with only few historical examples of CCP defaults.

In general, AACB strongly believes in a more mono-product or vertical model at CCPs; this means segmented default funds for different asset classes, each with appropriate risk weightings. We believe this would be beneficial from both a Risk Weighted Asset (RWA) perspective, as well as for the eventual recovery or resolution of a CCP. For example, pure OTC segments should have a default fund and default waterfall completely segregated from ETD default funds and waterfalls because the 1.) asset classes, 2.) the markets, and 3.) participants differ substantially in terms of risks, liquidity and likelihood of prompt replacement of the contracts. Furthermore, the recovery or resolution of a mono-product CCP is likely to be more straightforward compared to a multi-product CCP in times of stress. More differentiation between ETD and cleared-OTC could also prevent the spill-over effects where a problem arising in the cleared OTC market might spread to otherwise functioning ETD markets and vice versa.

[2] There are also bilateral, CCP-cleared trades in derivatives that are fungible with ETD. In the following OTC derivatives do not include these because resulting positions can in principle be closed out on exchange/MTF.

2. Appropriate tooling for the recovery of ETD / OTC clearing CCPs as a result of default losses

AACB broadly agrees with the responses given by the Futures Industry Association (FIA), the Institute of International Finance (IIF), the International Swaps and Derivatives Association (ISDA), The Clearing House (TCH), and the Global Financial Markets Association (GMFI).

It should be underlined that rulebooks of CCPs already provide for a range solutions to return to a BAU scenario upon the default of a clearing member. Furthermore, as part of the PFMI (implemented in the EEA as EMIR), each CCP has a "waterfall scenario"[3] in place for the management of member defaults in extreme, but plausible market conditions. These default management processes (DMP) already include 1.) use of the margins and default funds contributions of the defaulting member, 2.) use of the skin in the game (SIG) of the CCP, 3.) depletion of the default fund contributions of all members, and 4.) additional cash calls to the remaining members. It will be only after the measures above are exhausted or have failed that other recovery, and eventual resolution scenarios, come into play in order to return the CCP to a matched book and cover losses.

We believe that any additional measure to safeguard resilience of the CCP should become part of a recovery framework that is robust, member-led[4], tailored to the CCP and clearly defined in the rulebook and/or recovery plan (the latter should available to clearing members). In general, we believe the rulebook-led recovery should be exhausted prior to any intervention by the resolution authority (RA). Only if the rulebook-led measures are not successful, losses are unsustainable, or extreme market conditions dictate so, we believe intervention by a RA is justified. The RA should continue, where possible, the rulebook-led measures and sequence of the available tools in order to ensure continuity and predictability for all members and stakeholders affected.

Below, we have listed a range of rulebook-led measures that could be possible options in a recovery and eventual resolution scenario.

Auctions:

Most CCP rulebooks already prescribe auction processes to ensure the return to a matched book as part of their DMP. Such auctions should be subject to clear rules and guidelines and should continue as long as necessary with limited options for CCPs to reject bids, unless such bids are not economically reasonable.

In any case, we believe that only the depletion of the waterfall resources and an unsuccessful auction could trigger the further sequence of other tools.

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[3] EMIR describes 'default waterfall' as following:
EMIR article 42(3): The default fund shall at least enable the CCP to withstand, under extreme but plausible market conditions, the default of the clearing member to which it has the largest exposures or of the second and third largest clearing members, if the sum of their exposures is larger.
EMIR article 43(1): 'Skin in the game' (SIG) of the CCP.
EMIR article 43(2): SIG and default fund must be enable the CCP to withstand the default of at least the two clearing members to which it has the largest exposures under extreme but plausible market conditions.
EMIR article 43(3): A CCP may require non-defaulting clearing members to provide additional funds in the event of a default of another clearing member. The clearing members of a CCP shall have limited exposures toward the CCP.

[4] AACB believes the CCP risk committee is the most appropriate body to define such measures.

Increased skin-in-the game:

AACB supports a more substantial "skin in the game" of the CCP, both at the beginning of the default waterfall before the CCP uses any funded or unfunded mutualised resources and after assessments on clearing members.

Standardised Loss Allocation Mechanisms:

AACB is a strong proponent of a loss allocation mechanism to divide default losses between market participants (including exchanges and buy-side) after the depletion of the default waterfall of the CCP, prior into entering into resolution. Since all participants in the chain benefit from the efficiency, security and guarantees provided by the CCP model, AACB believes that it is logical that all parties in the chain contribute in case of CCP default losses. It should be stressed here that all losses incurred in this way by clearing members should result in equity participations and/or senior debt claims. Such a mechanism requires careful calibration; in order to safeguard a level playing field, a loss allocation mechanism standard should be based on global standards rather mandating it through CCP's internal rulebooks.

Variation margin gains haircutting:

For 'variation margin gains haircutting' (VMGH) in particular, AACB believes a clear distinction is needed between ETD and cleared OTC products. Furthermore, it should take the crucial role of market makers and liquidity providers with matched books on multiple venues into account. We believe that VMGH for CCPs clearing ETD markets could potentially have disastrous effects with key market participants running for the exit as quickly as possible:

(a) For ETD market participants, VMGH resembles Partial Tear Up (PTU) because the contracts subject to VMGH are no longer honoured by the CCP while participants are still bound by them. In this way, VMGH is worse than PTU because with PTU or close-out netting at least a possible loss is known at a certain point in time.
(b) Any participant holding economically hedged positions at different CCPs will no longer know to what P&L it will have to hedge.
(c) Any participant holding economically hedged positions with underlying instruments/commodities held outside the CCP will no longer know to what P&L it will have to hedge.
(d) For any CCP clearing futures and options, participants holding hedged positions in futures vs. non-future style options will end up with an unhedged position under VMGH. This is because the VM on futures is not (fully) paid out/collected under VMGH, whereas the mark-to-market of non-future-style options will change (and thus initial margin (IM)). As a result, a hedged position suddenly becomes an unhedged position even within the same CCP. As a result,the affected participant will no longer know what P&L it will have to hedge.
(e) In the case of interoperable CCPs, VMGH will affect the other functioning CCP(s).
(f) AACB fears that using VMGH will be the death bell to the market the CCP clears; market makers and liquidity providers will not have any incentive to quote/trade if after VMGH it is completely uncertain what kind of positions they get or will end up with. As explained above, a position with VMGH cannot be hedged. Close-out netting might even be preferable to VMGH as a possible loss would at least be certain at the time of close-out netting. Furthermore, if VMGH continues for an indefinite time, losses can be indefinite and not limited, especially in stressed market situations, e.g. when trading is suspended on the market cleared by the CCP.

Given these considerations, it must be kept in mind that ETD are mostly short-term compared to OTC contracts such as IRS, and are traded on or relate to liquid, fast-moving markets that could aggravate the problems named above.

As a result, in a time when continued market liquidity is crucial, we believe that VMGH could have the opposite effect as market makers would no longer be willing to provide liquidity anymore.

AACB believes that VMGH could be an appropriate tool only in the following very limited circumstances:

(a) Cleared OTC markets without market makers or liquidity providers;
(b) Long-term contracts (VM affected by VMGH is comparatively minor);
(c) Contracts which are difficult to replace with contracts at another CCP;
(d) Where VM applies to all contracts cleared and not just to a part of them (future-style products vs. non-future-style products);
(e) VMGH should be restricted in the number of business days;
(f) VMGH should only be applied under the supervision of competent authorities or the RA; and
(g) Any loss incurred by VMGH should give rise to senior debt claims.

AACB believes that any possible use of VMGH should be further investigated while carefully taking all relevant aspects as mentioned above into account.

Initial margin haircutting:

With regard to 'initial margin haircutting' (IMH), AACB supports the joint industry response of the Futures Industry Association (FIA), the Institute of International Finance (IIF), the International Swaps and Derivatives Association (ISDA), The Clearing House (TCH), and the Global Financial Markets Association (GMFI).

Partial tear-up:

Another scenario in recovery or resolution could be partial tear-up (PTU) or close-out of the contracts, with the applicable methodology and sequence based on pre-defined arrangements in the rulebook. AACB believes in a sequential approach starting with a very limited set of contracts that could gradually expand if absolutely necessary. In return, clearing members should receive either equity in the CCP (or its holding company) or a senior debt claim based on the fair value of the contracts subject to PTU. At the same time, the pricing of such contracts could become difficult depending on 1.) the financial instrument cleared, 2.) the underlying market cleared, 3.) the market conditions, and 4.) the availability of reliable reference prices. As a result, PTU should only applied under the supervision of the competent authorities or the RA. In addition, AACB urges that PTU follows the procedures as pre-defined in the rulebook.

External liquidity providers:

AACB sees the benefits of central banks as a *liquidity provider of last resort.* AACB appreciates that this could lead to a certain degree of "moral hazard", but believes that this should be supported by additional governance and oversight of CCPs by central banks.

For further questions, please contact AACB Global Regulatory Affairs via aacb.regulatory@nl.abnamro.com

Yours sincerely,

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