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Reference Guidance on CCP Resolution and Resolution Planning
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Optiver would like to thank the FSB for the opportunity to provide comments on the Financial Stability Board's Consultative Document "*Guidance on Central Counterparty Resolution and Resolution Planning*".

About Optiver

Optiver is a leading global electronic market maker, focused on pricing, execution and risk management. From our offices in Amsterdam, Chicago, Sydney and Shanghai, we provide liquidity to financial markets around the world, using our own capital, at our own risk, trading a wide range of products: listed derivatives, cash equities, ETFs, fixed income and foreign exchange. Our independence allows us to objectively improve the markets and provide trading efficiencies for end investors.

Below you will find Optiver's response to the consultative document. For questions or further information about our views on resolution and resolution plans for CCP's you can contact Willem Sprenkeler, Manager Corporate Affairs, at willemsprenkeler@optiver.com or +31 (0)20 708 74 93.

Resolution of CCPs

CCPs perform an extremely important and critical role in financial markets. Optiver therefore welcomes recent legislative proposals and guidance documents from international regulatory and legislative bodies to ensure that CCPs and national authorities have the means to act decisively when a CCP is faced with large and uncovered losses. We believe the proposed FSB guidance will contribute to the aim of assisting authorities in their resolution planning and promote international consistency in this area. The guidance will also help to avoid the costs associated with the restructuring and the resolution of failing CCPs from falling on taxpayers.

The only real concern that we have with regard to the proposed guidance is the concept of variation margin gains haircutting - as mentioned in §2.10 of the FSB document - as a potential tool for resolution authorities. Below we will explain the specific reasons for our concerns.

1) *Variation margin is not always a profit*

For a CCP that has entered in a recovery or resolution scenario, the variation margin (gains) from members would appear to be an attractive source of funding. Firstly, the money is readily available at the CCP. Secondly, it seems only fair that those members that benefit the most when a CCP survives (i.e. those with a 'profitable' position) also significantly contribute to the survival of the CCP. However, for market makers the variation margin gains do not represent the profit of a portfolio; instead, the gains in the variation margin of derivative positions are generally offset by losses of positions in other instruments (often at other CCPs) that are used to hedge these positions. Market making firms, just like CCPs, effectively run a 'matched book'.

When a CCP is in financial trouble due to a Clearing Member default, market volatility and volumes are likely to be very high, resulting in large gross positions at market makers, while maintaining a net matched book. The large gross positions result in *extremely* large variation margin 'profits' and 'losses' on futures positions. A haircut of the variation margin gains returning to a matched book by the CCP is effectively achieved by creating an un-matched book for market makers (and other firms that have tried to lower their risk by hedging their positions). These haircuts could easily lead to a situation where that market maker will have to default on its obligations arising from the loss-making counter (hedge) position.

2) Violation of the NCWO principle

An important principle of the recovery and resolution rules is the 'no creditor worse off' (NCWO) principle. For market making firms (and other institutions that hedge positions) the impact of VMGH is completely dependent on (1) which products they have traded (e.g. options or futures) and (2) which side of the trade they are on (the profitable or the loss making side). So some market makers will be completely unaffected by VMGH, while others will be potentially put out of business. For them it would be better if the CCP went into insolvency and the losses would be evenly shared amongst all members. As such, we believe VMGH violates the NCWO principle.

3) Complication of the auction process

An important element of recovery and one of the first steps in the default waterfall is the auction process. In the auction the CCP 'sells' the portfolios of the defaulting clearing member(s) to market participants. If VMGH is a tool afforded to the CCP or resolution authority the market participants bidding on portfolios will, in their bids, take into account the possibility that a haircut will be applied at a later stage on the margin they may be receiving associated with the acquired portfolio. So applying VMGH could have a chilling effect on participants' willingness to bid during the auction, forcing them to provide worse prices - or not participate at all - in the auction to compensate for the additional risk. This limits the likelihood of a successful recovery.

4) VMGH introduces contagion risk

The market and their clearing members may be able to cope with the demise of one or two market makers (besides the defaulting clearing members), but when VMGH is applied, many market makers could see one side of their trading book (i.e. the profitable side) being 'haircut' to a point where their equity is wiped out. This means that these market makers may have to default on their losses arising from the hedge positions, which could subsequently seriously affect additional clearing members who have guaranteed these market makers' positions to CCPs. As a consequence, due to the additional defaulting clearing members, it may also seriously affect additional CCPs where the hedge positions are held. Also, VMGH will lead to extreme price distortions, as correlations between instruments (e.g. between futures and a basket of shares or the underlying index) will break down as a result of VMGH. This could in turn lead to further margin calls (and subsequent defaults).

5) Threatening the smooth operation of the markets

In situations of such market turbulence (as will likely be the case when a CCP is in trouble) the demand for liquidity from market makers is high. But VMGH will disproportionately affect exactly the kind of firms that are most needed in times of crisis. When market makers would start to suspect that a resolution authority may potentially be applying VMGH, they will have no choice but to stop providing liquidity on all the exchanges connected to that CCP. A shortage of liquidity in turbulent markets often leads to extreme price movements (flash crashes).

Besides stopping to provide liquidity, market makers may be forced to reduce their positions, as they realise that the exposure to the CCP is a multiple of what they thought under a going-concern scenario, thereby adding to the volatility. Effectively, this could create the CCP-equivalence of a bank-run. Combined with the extreme price distortions and low liquidity that will occur due to VMGH, it becomes clear that VMGH is threatening the smooth operation of the financial markets.

Conclusion

Optiver believes that CCPs play a crucial role in the safe and efficient functioning of financial markets, and therefore supports efforts that give regulators and CCPs effective tools to ensure that a CCPs' functions are preserved in times of crisis and/or that there are effective resolution plans. We think that most of the resolution tools identified in the draft FSB guidance can contribute to that goal.

However, we believe that the specific tool of VMGH could potentially create far bigger problems than it is intended to solve. It disproportionately affects market makers, allocates losses randomly and is therefore in contradiction with the 'no creditor worse off' principle. It affects the smooth operation of the respective market, and it introduces contagion risks with potential systemic implications in financial markets. And lastly, due to the interconnectedness of CCPs with trading venues, it could frustrate the smooth functioning of those other markets.

For the reasons mentioned above, we strongly recommend to refrain from using VMGH as a tool for (recovery or) resolution of CCPs. If ever allowed as a (recovery or) resolution tool, VMGH should only applied be in the very last resort and only after careful consideration by the resolution authority of the systemic consequences, as well as the negative impact on the smooth operation of the markets.