



# asset management group

February 11, 2019

Financial Stability Board

[fsb@fsb.gov](mailto:fsb@fsb.gov)

**Re: Response to Discussion Paper of the Financial Stability Board (“FSB”) regarding Financial Resources to Support CCP Resolution and the Treatment of CCP Equity in Resolution dated 15 November 2019 (“Discussion Paper”)<sup>1</sup>**

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association’s Asset Management Group (“AMG”)<sup>2</sup> appreciates the opportunity to respond to the FSB Discussion Paper that sets out (i) the considerations that may be relevant for authorities and crisis management groups when evaluating whether existing financial resources and tools are adequate to implement resolution strategies for individual central counterparties (“CCPs”) and (ii) the considerations that could guide authorities in developing possible approaches to the treatment of CCP equity in resolution.

AMG appreciates the continued efforts of the FSB, together with the Committee on Payments and Market Infrastructure (“CPMI”) and the Board of International Organization of Securities Commissions (“IOSCO”) to facilitate discussions and the development of policies regarding CCP resilience, recovery and resolution.

## 1. FINANCIAL RESOURCES FOR CCP RESOLUTION

### 1.1 General Comments on financial resources for CCP resolution

AMG supports equitable CCP recovery and resolution policies that specifically avoid tax payer bailouts. Effective CCP policies reinforce investor confidence which ultimately leads to improved market stability and encourages the central clearing of derivatives. AMG believes the suggested five-step process is a useful starting point for the relevant authorities to use when evaluating the financial resources and tools available for the resolution of a CCP (as to which, see the specific responses set out in Section 1.2 of this letter).

However, as noted in previous responses by AMG to public consultations published by the FSB, CPMI and IOSCO<sup>3</sup> AMG and its members have fundamental concerns in relation to the assessment and allocation of the financial resources available to CCPs as it relates to end-users and customers (i.e. clearing participants that are not clearing members of a particular CCP). As previously identified and discussed at length by AMG and its members, the below are of paramount importance to AMG and its members and are pertinent to the present consultation. They are therefore summarized as follows:

<sup>1</sup> FSB Discussion Note, available at: <http://www.fsb.org/2018/11/financial-resources-to-support-ccp-resolution-and-the-treatment-of-ccp-equity-in-resolution/>.

<sup>2</sup> SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG’s members represent U.S. and global asset management firms whose combined assets under management exceed \$45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. They use futures and cleared swaps, as well as other derivatives, for a range of purposes, including as a means to manage or hedge investment risks such as changes in interest rates, exchange rates, and commodity prices.

<sup>3</sup> AMG Public Consultation Response (September 22, 2017) available at: <https://www.sifma.org/wp-content/uploads/2017/09/SIFMA-AMG-Comments-on-the-CPMI-and-IOSCO-Consultation-Framework-for-Supervisory-Stress-Tests-of-CCPs.pdf>; AMG Public Consultation Response (October 17, 2016) available at: <http://www.sifma.org/wp-content/uploads/2017/05/sifma-amg-submits-comments-to-cpmi-and-iosco-on-the-consultative-report-and-fsb-discussion-note-regarding-ccp-resiliency-recovery-and-resolution.pdf> (“October 2016 AMG Response”); AMG Public Consultation Response (October 23, 2015), available at: [https://www.cftc.gov/sites/default/files/idc/groups/public/@aboutcftc/documents/file/mrac110215\\_sifmaamgletter.pdf](https://www.cftc.gov/sites/default/files/idc/groups/public/@aboutcftc/documents/file/mrac110215_sifmaamgletter.pdf).

New York | Washington

120 Broadway, 35th Floor | New York, NY 10271-0080 | P: 212.313.1200 | F: 212.313.1301  
[www.sifma.org](http://www.sifma.org)

(a) *Non-defaulting customer assets*

AMG believes that any assessment of the financial resources and tools available for business as usual, and recovery and resolution of a CCP must be predicated on the following principles with respect to the use of assets belonging to non-defaulting customers:

- **CCP Business as Usual.** Non-defaulting customer assets must be excluded from the calculations of financial resources available in the CCP's default loss waterfall. CCPs, clearing members as well as regulators and resolution authorities must never assume that non-defaulting customer collateral will or should be available to backstop poor CCP risk management practices and regulators should prohibit CCPs from adopting risk management procedures that permit the CCP to use the collateral or other assets of non-defaulting customers to cover credit or liquidity shortfalls. It is not appropriate to require end-users such as pension funds, life insurers, U.S. mutual funds, UCITS and other investors who have no control over CCPs' risk management practices and indeed little transparency regarding such matters, to use their assets to cover CCP shortfalls following a default.<sup>4</sup> End-users do not have a seat in risk or default management committees in the same way that CCP risk management and clearing members do. This means, for example, that they have no insight or control into what products are accepted for clearing and on what basis, or the contagion risk they pose to other products cleared by the CCP. It is inappropriate to allocate any losses to non-defaulting customers who are unable to quantify or control the risk of such losses; risk allocation to non-defaulting customers poses an unquantifiable risk to financial stability.
- **Recovery.** Regulators should strictly prohibit CCPs from taking non-defaulting customer assets to cover CCP shortfalls when a CCP is in recovery. Although returning the CCP to a matched booked is clearly a key imperative, any mutualization of losses amongst non-defaulting customers is an extraordinary measure that regulators should only permit by a resolution authority as a last resort after equity holders have been allocated losses and the CCP has replenished its skin-in-the game and clearing members have recapitalized contributions and existing and new equity holders have had an opportunity (being appropriately incentivized) to recapitalize the CCP. In particular, equity holders stand to benefit from the profitable performance of the CCP and so should also stand responsible for losses ahead of customers and end-user. If customers and end-users are put in a worse position than equity holders this potentially disrupts the rational incentives for them to ensure that the failing CCP can continue as a going concern. In other words, a proposed risk-mitigant may end up undermining the very goal of central clearing. For this reason, CCP resiliency is that much more important. If the recovery process is working well and non-defaulting customer assets are protected customers may well continue clearing allowing the CCP to flatten its exposure and return to business as usual ("BAU") and ultimately profitability. AMG refers to its letter of October 17, 2017<sup>5</sup> which describes fully AMG's position with respect to variation margin gains haircutting ("VMGH") and other extraordinary mechanisms such as partial and full tear-up and forced allocations. Recovery may be preferable to resolution and it is important to get incentives right to enable the CCP to return to a matched book and to return to BAU. Non defaulting customers will be incentivised to protect their assets by leaving a distressed CCP if their assets are at risk. On the other hand if the recovery process is working well and assets are protected, customers may well

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<sup>4</sup> AMG notes that in the "Incentives to central clear over-the-counter (OTC) derivatives – A post implementation evaluation of the effects of the G20 financial regulatory reforms – final report" published by, *inter alia*, the FSB, CPMI and IOSCO on 19 November 2018 (available at: <https://www.bis.org/publ/othp29.pdf>) certain respondents indicated that concerns related to recovery and resolution for CCPs was a factor influencing incentives to centrally clear. AMG agrees that recovery and resolution for CCPs is a key area of focus for end-users and all stakeholders should keep in mind the fundamental benefits of central clearing from a systemic risk perspective when considering CCP recovery and resolution.

<sup>5</sup> *Id.*

continue clearing allowing the CCP to flatten its exposure and return to BAU and ultimately profitability.

- **Resolution.** Even in resolution, loss mutualization amongst the assets of non-defaulting customers should only be permitted under the exclusive supervision of a resolution authority and only if there are no other means available to allocate losses, return the CCP to a matched book or wind-up the CCP in an orderly fashion. If loss mutualization is undertaken by a resolution authority then it should be done so within strict parameters that consider how it can be performed in the fairest possible manner, taking into account in particular the nature of customers' and end-users' directional portfolios and the impact on financial stability. In this regard AMG agrees with the FSB's comment on page 4 of the Discussion Paper, where the FSB notes that "*in addition, the fact that many CCPs or authorities may not know the identity and distribution of end user clients, potential impacts of the use of such loss and position allocation tools would likely be even more difficult to predict than for tools that allocate losses only to clearing members.*"<sup>6</sup> There are also potential systemic risk implications of using loss allocation tools against end-users and customers. For instance, VMGH can impair an end-user's ability to meet margin requirements at other CCPs or when facing other counterparties raising possible contagion issues. There must also be a clear compensation mechanism for those customers who have been subject to a loss as a result of loss mutualization. Such customers should be entitled to a high ranking claim in the case of a liquidated CCP or some form of compensation payment in the case of a CCP that continues as a going concern following a successful resolution. Finally, the CCP and its equity holders should be responsible for continuing costs of operating post recovery and resolution. AMG welcomes FSB's focus on these issues and the conclusion that further work and attention is needed and ultimately guidelines for CCPs and resolution authorities alike are required. We refer to Section 2 for a discussion of compensation mechanisms.

As set out in more detail below there are two themes that are relevant to each of these stages. These are transparency and interconnectedness.

- **Transparency.** End-users who are mandated to clear have no choice but to accept a degree of exposure to CCPs notwithstanding that they are, unlike the management of the CCP itself or clearing members and ultimately the resolution authority, remote from any decision making regarding the design and risk and default management of a CCP. As such transparency regarding the use and status of financial resources, loss allocation tools and the prospect of successful recovery or resolution are of utmost importance for the decision making and risk management of end-users regarding their assets and ultimately their own financial stability which is core the issue of systemic risk. In addition, AMG believes it is critical that all market participants (including customers and end-users) are regularly informed of the status and nature of the recovery or resolution plans so that they can continue to take informed commercial decisions that minimize risk in both recovery and resolution. AMG's members ask that CCPs and resolution authorities are required to publish and keep up to date a "plain English" disclosure of how the allocation provisions of a CCP and the resolution tools of a resolution authority will operate (both in BAU, recovery and resolution) and the nature of the risks that end-users / customers may be exposed to through the operation of such provisions or tools.
- **Interconnectedness.** Resolution authorities, regulators and CCPs should take into account the interdependencies between various actors in the cleared ecosystem, including CCPs, clearing

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<sup>6</sup> Discussion paper, page 4.

members, cleared products, liquidity providers, and service providers and the potential impacts of any recovery and resolution tools given such interconnectedness. This interconnectedness should not only be considered at the point of utilising recovery and resolution tools, but should be continually captured and tested in stress tests and any related disclosure so that all participants, including end-users can make better, risk based assessments, of which CCPs to utilize.<sup>7</sup>

(b) *Non-default losses must be the sole responsibility of the CCP*

AMG believes that non-default losses must be the sole responsibility of the CCP.

The CCP is entirely responsible for managing the operational risks associated with running its business as a clearing house and therefore it must be the person that takes economic responsibility for the losses arising from such risks. Customer assets must be fully protected through clearly identified resources that will cover this risk. If the allocation of non-default losses is not aligned with the CCP's responsibility and such losses are instead allocated amongst clearing members and their customers there is a real risk of moral hazard as the CCP is not properly incentivized to manage, mitigate and respond to operational risks and resultant non-default losses.

Customers have absolutely no ability to manage or quantify the operational risks associated with clearing – the only entity responsible for managing those risks is the CCP itself. AMG is therefore strongly opposed to any proposal (in resolution or otherwise) that involves customer assets being put at risk to cover the economic consequences of a CCP's failure to properly manage operational risk.

AMG believes that the CCP must have sufficient alternative resources and tools to cover non-default losses (such as a guarantee from its parent company or a third party, insurance or higher pre-funded capital requirements). Stress tests should, as far as possible, also cover non-default loss scenarios and not be limited to default loss scenarios. There should also be greater transparency provided to market participants regarding CCPs preparedness for non-default losses, the size of the risks and associated CCP resources allocated to dealing with such risks, so that end-users can make informed decisions regarding their use of CCPs. The interconnectedness with other CCPs and other critical infrastructure (e.g. custodians and exchanges) should be considered in the context of non-default losses. AMG notes that the origin and potential losses are wide ranging and remain largely untested; financial resources available to cover such losses should be sized accordingly.

(c) *CCP skin-in-the-game*

CCP skin-in-the-game should reflect a meaningful percentage of the risk that CCPs manage under both default and non-default loss scenarios. Current requirements do not meet this standard. Properly sized skin-in-the-game is an essential part of aligning the incentives of the CCP, clearing members and customers. As with the allocation of losses to non-defaulting customers, it is not equitable that CCP profits accrue to equity holders but CCP losses can be allocated to clearing members and ultimately customers.

(d) *Public disclosure by CCPs should be comparable, transparent and reliable*

Regulators should strengthen Public Quantitative Disclosure so that customers and fiduciaries that act on their behalf can effectively assess CCP resiliency before a crisis occurs and recovery or resolution is

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<sup>7</sup> In this regard AMG notes the comments provided by Vanguard in relation to the consultative report on framework for supervisory stress testing of central counterparties by the CPMI and ISOCO published on 10 April 2018 and available here: <https://www.bis.org/cpmi/publ/d176.htm>.

necessary. In doing so regulators would harness the analytical abilities of the market place to scrutinize the CCP risk controls and incentivize CCPs to pass the public test in addition to various non-public evaluations undertaken by regulators and the CCPs.

Given that Public Quantitative Disclosure is relied upon by market participants including AMG members with a fiduciary duty to their clients, AMG recommends that:

- All Public Quantitative Disclosure should be accurate, audited and there should be accountability for both the CCP and the auditor if there are material inaccuracies in such disclosure.
- All Public Quantitative Disclosure should be promptly made available on a central website.
- All Public Quantitative Disclosures should be expanded so that they require the running and full disclosure of “benchmarking” stress tests. Currently stress test results are not supported by disclosure of the accompanying scenarios and parameters. Whilst the output of stress tests has some value, AMG members cannot make informed comparisons between CCPs based on this output alone. AMG members are fiduciaries that need to make decisions in the best interests of their clients and this proposal would assist with that assessment. Further, the results of these stress tests could inform CCP’s risk management decisions, which with the correct incentives they should be motivated to do.

Regulators should also ensure that lessons learned from clearing member or customer defaults are shared with a broad range of market participants and CCP default drills include investors and asset managers. In addition, AMG believes that regulators should require CCPs to disclose clearly in their rulebooks the potential impact of recovery and resolution tools on customers and end-users. This is currently not something provided for by CCPs but would serve to further harness the power of market scrutiny to ex-ante determine CCP suitability and resilience.

## 1.2 Responses to Consultation Questions on financial resources for CCP resolution

- (a) Do you agree with the suggested five-step process to evaluate the financial resources and tools for resolution? What other elements, if any, should be considered?

The suggested five-step process is a useful starting point for the relevant authorities to use when evaluating the financial resources and tools available for the resolution of a CCP.

Although AMG welcomes the attempts to formalise a process for evaluating the resources and tools available for resolution of CCPs, as set out in Section 1.1 above, AMG has fundamental concerns with respect to the allocation of resources available to CCPs (both in resolution and otherwise) and the impact this may have on customers’ assets and positions. Given that the five-step process will likely reveal that a CCP does not have sufficient available resources in relation to default and non-default losses, the CCPs and regulators should take action as a priority to resolve this without assuming recourse to the assets and positions of customers and end users.

- (b) The discussion paper outlines a number of CCP and product specific factors that authorities should consider when assessing the adequacy of resources and tools in resolution. Are these factors appropriate or are there other factors that should be considered?

AMG agrees that the relevant authority must have regard to the factors identified when assessing the adequacy of the resources and tools available in resolution. In particular:

- (i) The FSB notes in the Discussion Paper that *given “the fact that many CCPs or authorities may not know the identity and distribution of end use clients, potential impacts of [such] loss and position allocation tools would likely be even more difficult to predict than for tools that allocate losses only to clearing members”*.<sup>8</sup> AMG agrees that the resolution authority must have particular regard to the fact that the universe and distribution of end-users and customers and the impact that loss allocation on end-users and customers may have on systemic financial stability will not be fully known to the CCP or the authority at the point it seeks to allocate losses. This strongly supports AMG’s view that any allocation of default losses to end-users and customers must only be permitted as a last resort (and after losses are allocated to equity holders) and within strict parameters that are disclosed ex ante and once the resolution authority has taken control from the failing CCP’s management. It also strongly supports the view that end-users and customers must be compensated for any losses that are allocated to them.
  - (ii) The FSB specifically notes in the Discussion Paper that “multi-service CCPs” and “CCPs with interoperability arrangements” may affect the design of a resolution strategy and resolution plan.<sup>9</sup> AMG agrees that both CCP interoperability and the linkage between different services at a given CCP should be taken into account when carrying out the five-step assessment process.
- (c) *Should the assessment of financial resources for CCP resolution take into account (a) different CCP ownership structures; (b) different CCP organizational structures; or (c) the products cleared by the CCP? If so, how?*

Yes, any assessment of the financial resources of a CCP for resolution must necessarily take into account the CCP’s ownership structure, the organizational structure of the CCP and the products that are cleared by the CCP. It would not be possible to assess the financial resources available for CCP resolution without this information. Resolution authorities must also take steps to assess the population and distribution of customers using a given CCP and factor this in to their assessment of financial resources available for resolution, bearing in mind at all times the overarching principle that allocating default losses to non-defaulting customers is a last resort as discussed above.

With regard to the organizational structure of the CCP, AMG notes that the extent to which a given business unit or service line within the CCP is operationally, legally and/or economically segregated from another business unit or service line should be taken into account by regulators and resolution authorities when assessing CCP resilience and resources available for CCP resolution.

With regard to the nature of the cleared products, AMG notes that some cleared products are inherently more risky than others and the resolution authority should take this into account when assessing financial resources for CCP resolution. End-users and customers are very rarely involved in the discussions around whether a particular new product should be introduced within a CCP’s service and the risk management processes in relation to such a product<sup>10</sup>, so it is very important that these groups are properly protected

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<sup>8</sup> Discussion Paper, page 4.

<sup>9</sup> Discussion Paper, page 5.

<sup>10</sup> For example, the U.S. Commodity Futures Trading Commission permits self-certification regime for the clearing of certain virtual currency products (e.g. bitcoin futures and bitcoin options). See 17 CFR §40.2.

through an adequate and dynamic assessment of the resources available for CCP resolution and that such assessment is sensitive to the nature of the cleared products at a given CCP.

- (d) Step 1: The discussion paper outlines a number of high-level default and non-default loss scenarios that might lead to resolution. Does this cover a sufficiently broad range of scenarios? What other relevant scenarios, if any, should authorities consider in resolution planning?

The list of scenarios is sufficiently broad to capture current known types of non-default loss.

However AMG notes that many of these risks are by their nature very difficult to predict and quantify. There have also been few examples of these losses arising in practice to date. Given that non-default losses could have a fundamental impact on the solvency of a CCP it is particularly important that regulators keep the list of potential non-default loss scenarios under review and maintain flexibility to deal with new types of non-default loss that may arise as the markets and business environment that CCPs operate in evolves over time. In addition, if a non-default loss does occur, AMG would support efforts to ensure that the nature and losses stemming from such event are made public.

- (e) Step 2: Are the considerations for conducting an evaluation of existing tools and resources appropriate and comprehensive? If not, what other considerations should be included?

AMG believes that non-default losses must be the sole responsibility of the CCP. AMG strongly objects to the inclusion of the third item under the “Non-Default loss scenarios” on page 12 of the Discussion Paper where the FSB implies that non-default losses may be allocated to “participants (including clearing members)”. As set out above, non-default losses must be the sole responsibility of the CCP and in no circumstance should participants (in particular customers and end-users) be responsible for such losses.

The remainder of the response to this question considers default losses only.

Auctions provide end-users with a meaningful chance to contribute to CCP risk management. AMG believes that open auctions during recovery, with appropriate incentives for clearing members such as juniorization and seniorization of default fund contributions, are the best process to return to a matched book. AMG continues to encourage auctions to be open to a range of market participants without barriers, where this is warranted by the product type, to improve liquidity and increase the likelihood that the CCP will return to a matched book quickly.

In relation to variation margin gains haircutting, tear-up (both full and partial) and allocation, AMG strongly believes that these mechanisms must not be undertaken with respect to assets and positions of a non-defaulting customer until the CCP is in resolution and there are no remaining alternatives after clearing member equity holders (and potential equity holders) have had an opportunity (with appropriate incentives) to recapitalize the CCP. To the extent they are undertaken, there must be clear processes and parameters to ensure they are implemented fairly, proportionately and for a very limited time.

In addition to the fundamental problem of allowing customer property to be used by a failing CCP, VMGH is an arbitrary measure that results in ex ante unquantifiable exposure for customers. VMGH arbitrarily takes from market participants with net positive cleared positions. As such, “gains haircutting” disproportionately hurts directional market participants who happen to have net positive cleared positions even though directional participants bring no greater risk than participants who may have a net neutral position. Market participants like mutual funds, hedge funds and pension funds typically are taking a market view or hedging

risk not held at the clearinghouse and, as a result, would be forced to pay proportionally more than other market participants with open positions. In addition, to the extent the cleared position is being used to hedge an uncleared position, customers would suddenly become exposed to market movements at a difficult time to make adjustments to positions.

Given the unprecedented nature of VMGH and the inability to calculate its impact ex ante, VMGH would create untenable challenges for asset managers handling their clients' investments as a fiduciary responsible for acting in their best interests. Should an asset manager, as a fiduciary, continue paying variation margin that is owed if it knows that repayment will not be in full? How can asset managers manage the client's broader investment without knowing whether margin, which would be applied to support other investments, will not be fully returned? How should daily net asset value ("NAV") be calculated when some of the investors' margin has been taken and more may be taken in future days?

Due to the impact VMGH has on investor behavior, it will have procyclical consequences that will undermine the market stability sought. VMGH will likely lead to earlier close outs in anticipation of this consequence, potentially resulting in a run on the CCP at the first signs of clearing members' instability, which would accelerate the CCP's failure and undermine other recovery tools. Gains haircutting undermines investor confidence in centrally cleared markets even during times of non-stressed market conditions; if the regulators do not prioritize customer protection, transactions may be driven where possible to the uncleared space where, ironically, investors could achieve greater protections against loss mutualization through third party custody arrangements. Clearly, this result was not the intention of G20 Leaders in making the commitment to clear standardized OTC derivatives contracts through CCPs.

Further, delaying resolution by resorting to VMGH reduces the incentives of equity holders to voluntarily inject capital to avoid the write down of their equity position. Its use also delays the ability of new equity rights to be granted to entities willing to recapitalize the CCP, which also could result in the CCP's debit being covered by resources other than non-defaulting customer assets.

Further consultation and comment is required to assess how loss mutualization can be achieved fairly such that all open contracts bear a proportionate share of losses. As discussed above, VMGH has been put forward as a tool to be used on a net (a/k/a portfolio level) basis. However, to apply VMGH on a net basis and not on a gross basis or upon the full net equity position means that the loss allocation will arbitrarily impact positions that happen to be positive on the days applied and will not impact participants with a flat position at the clearinghouse. Problems of fairness also arise from the use of VMGH on a gross (a/k/a position level) basis. For example, a curve trade whereby a market participant is exposed to the difference between two or more maturity dates for the same instrument (e.g., a calendar spread between the front month and next month of a futures contract), would become decoupled if VMGH applied on a gross basis. Rather than paying or receiving the variation margin reflecting the relationship between these related positions, the market participant would have to pay the full amount due on the out-of-the-money position and receive a discounted payment of the in-the-money amount due. In addition, any form of margin haircutting on cleared positions turn perfect or near-perfect hedges of positions held away from the clearinghouse into speculative ones. For example, a bond hedged by a credit default swap will become partially unhedged if margin payments are cut such that the investor, once agnostic to whether the bond or the credit default swap rose in value, is suddenly taking a market view.

For completeness, even though the Discussion Paper does not mention the following loss allocation mechanisms, AMG strongly objects to (i) using a portion of assets posted in good faith by end-users as initial margin (also known as "**Initial Margin Haircutting**" or "**IMH**") and (ii) any forced allocation that



requires clearing members to take on positions that they may not otherwise be prepared to absorb. These mechanisms could have a negative impact on the market if clearing members and end-users choose to close out positions instead of realizing these costs.

- (f) Step 3: Are the considerations for analyzing the hypothetical resolution costs (covering total losses and operational costs) appropriate?

Yes. However, although default loss costs and the mechanisms for allocating those costs are relatively well understood, there is not an equivalent level of detail in relation to non-default losses. Non-default losses can stem from a wide range of risks ranging from failure of a custodian to a cyber-security failure. These are generally speaking not “market events” and therefore it is not something that can be modeled through past behavior or probability. It will be very difficult to analyze resolution costs in relation to non-default losses in a way that is robust.

It is particularly important that regulators keep the list of potential non-default loss scenarios under review and maintain flexibility to deal with new types of non-default loss that may arise as the markets and business environment that CCPs operate in evolves over time. In addition, if a non-default loss does occur, AMG would support efforts to ensure that the nature and losses stemming from such event are made public.

- (g) Step 4: Is there merit in relevant authorities and CMGs conducting quantitative analyses for the purpose of identifying and sizing potential additional tools or resources for resolution purposes? If so, what quantitative analysis should relevant authorities and CMGs conduct and how could they obtain the necessary data?

Yes. AMG supports resolution authorities and CMGs trying to future proof the tools and resources for resolution through quantitative analysis.

- (h) Step 5: Are the considerations regarding potential means to address funding gaps (including of any proposals to reserve resources for use in resolution) appropriate? Do they adequately address the issues of availability, costs and benefits, impact on and interaction with recovery and business as usual? If not, how should they be framed?

AMG believes that any funding gaps identified should be the responsibility of the CCP to address and the assets of end-users and customers must not be used as a means to fill such gaps nor should end-user/customer assets be factored into the calculations of what adequate resources may be.

## 2. TREATMENT OF EQUITY IN CCP RESOLUTION

### 2.1 Responses to Consultation Questions on treatment of equity in CCP resolution

- (a) Do you agree that the key issues to CCP equity bearing loss in resolution have been accurately identified? Are there other key issues regarding equity bearing loss? What are they and how should they be addressed?

Generally AMG agrees with the presumption and the principle put forward by the Discussion Paper, which is that equity should be used to absorb losses in resolution ahead of non-defaulting customer property.

FSB notes in the Discussion Paper that “a resolution in which shareholders remain in place might raise concerns about whether such resolution achieves an optimal outcome, and could potentially give rise to moral hazard.”<sup>11</sup> AMG agrees with this statement. To the extent CCP equity holders are protected from default losses that fall on non-

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<sup>11</sup> Discussion Paper, page 18.

defaulting customers, this does not create the correct alignment of incentives on the CCP to manage adequately the risks it is paid to manage. Non-defaulting customers would effectively be sponsoring CCP equity holder profits. The FSB correctly notes that “*unlike clearing members and shareholders who may have more means to influence the risk profile of the CCP and its risk management, clients may have less opportunity to do so. To the extent that a CCP relies on tools (such as VMGH) that would be likely to result in a preponderance of losses falling on clients of clearing members, the incentives of CCPs, clearing members and clients may not be fully aligned.*”<sup>12</sup> AMG agrees with this and encourages any forthcoming policy in this area to ensure that the treatment of equity in resolution does not create or exacerbate moral hazard on the part of the CCP. AMG would support an effort by regulators and other organizations to ensure that CCPs are structured in a way which does not protect the CCP equity holders from losses in resolution through the use of limited recourse or similar structures.

As described above, AMG’s view is that allocation of losses to non-defaulting customers should be avoided in both recovery and resolution. However, to the extent that customers and end-users suffer losses they must be compensated for such losses. The form of compensation mechanism is complex and dependent on various factors, including local insolvency laws, and thus requires further analysis, but it must meet certain basic principles:

First, it must be in a form that can be accepted by customers or end-users. Compensation in the form of a true equity interest in the CCP is not acceptable to many end-user or consumers who may be prohibited from holding such instruments under their investment guidelines or mandates. In addition, even if there is no such prohibition many end-users or consumers will not be willing to accept such a form of compensation – end-users are not likely to have any desire or ability to hold an ownership stake in a CCP. The Discussion Paper analyses both (i) providing shares in compensation for any losses that are applied in resolution (see for example the discussion on page 25 of the Discussion Paper) and (ii) providing other instruments or claims against the CCP as compensation for any losses applied in resolution. AMG supports (ii) for the reasons above.

Second, the compensation must be senior to existing CCP equity.

Third, it must be appropriately structured so as to not negatively affect either the chances of the CCP returning to profitability or incentives for new equity investment but still reflect the economic loss that the customer has suffered.

AMG would support further efforts by authorities and CCPs to develop specific and exclusive details on the range of compensation mechanisms that could be made available. Whilst there is a lot more detailed work to do in this area, AMG is keen to ensure that a wide range of compensation options that meet the principles above are available to resolution authorities and are clearly set out in CCP rulebooks and related mandatory disclosure. Resolution authorities should have the ability to compensate parties that suffer loss through a range of tools such as new ownership interests in the CCP (to the extent the recipient is able and willing to accept this), senior claims against the future profits of the CCP and/or senior tradable debt instruments that repay the loss over a period of time. AMG would welcome the opportunity to review and comment on any proposed compensation mechanisms when available but the use of all loss allocation tools and processes for compensation must be known to all clearing participants ex ante.

As an aside, the Discussion Paper states in relation to default losses that “*typically, these arrangements allocate the majority of the losses to clearing members (and potentially non-member participants).*”<sup>13</sup> For the avoidance of doubt,

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<sup>12</sup> Discussion Paper, page 25.

<sup>13</sup> Discussion Paper, page 17.

AMG does not agree with this statement to the extent that it implies such losses should be allocated to customers or end-users; the allocation of losses to such persons must only be undertaken in resolution and once equity holders have been held fully accountable for the loss or other alternative mechanisms that avoid allocation of losses to non-defaulting customers have been exhausted.

(b) *Should the treatment of CCP equity in resolution take into account different ownership structures? If so, how?*

To the extent necessary to meet the aims set out in this letter, AMG believes that the treatment of CCP equity in resolution should be responsive to the corporate form of the CCP in question, its equity structure and whether or not the CCP is integrated with a broader corporate group.

The Discussion Paper notes that the treatment of CCP equity in resolution should consider the “*impact of different business models and legal structures of CCPs*”<sup>14</sup>, particularly if the CCP is legally or operationally integrated with other entities within a corporate group (such as an exchange). AMG agrees that a resolution authority should have regard to such factors when assessing how to deal with CCP equity on a case by case basis. To the extent there is a risk that imposing losses on equity could disrupt other functions within a CCP’s group this should be clearly communicated to market participants (including the customers and end-users) and the resolution authority should seek to minimize any such disruption. AMG also notes that the extent to which business units or service lines within a CCP are operationally, legally or economically linked is a relevant factor. Any compensation for losses should also take into account the ownership structure of the CCP following resolution – for example, if part of a CCP’s business has been transferred to a separate bridge entity as the Discussion Paper suggests, consideration should be given as to how any compensation will take this into account.

(c) *What are your views on the possible mechanisms for adjusting the exposure of CCP equity in bearing loss in resolution set out in Section A? What other possible mechanisms, if any, should be explored?*

AMG is generally supportive of the mechanisms proposed to the extent that they facilitate the use of CCP equity in resolution. AMG’s key concern is that if non-defaulting customer property is used there must be an adequate compensation mechanism in place to ensure that such customers have a right of recourse against the CCP and can benefit in the future profits of the business until the customer’s losses are covered.

(i) *Exposure of some or all of the equity of the CCP via modification of the contractual loss allocation arrangements.*

AMG is supportive of arrangements that would (i) increase the CCP’s skin-in-the-game exposed to losses that is as high up as possible in the loss allocation waterfall and (ii) introduce multiple levels of skin-in-the-game. Item (i) would ensure that the CCP is better incentivized to develop proper risk management tools, appropriately size initial margin and default fund contributions. Item (ii) would in addition ensure that the CCP’s management continues to be properly incentivized to adequately perform the risk management / loss allocation process notwithstanding that its original skin-in-the-game may have been utilized. This would also allow a greater amount of CCP equity to be exposed to loss in recovery as well as resolution, which AMG would support as it would reduce the possibility of non-defaulting customer property being exposed to such losses. Furthermore, the introduction of multiple levels of skin in the game may help to ensure the CCP is effectively incentivized throughout the entire default management process.

(ii) *Full or partial write down of equity and cancellation of existing shares.*

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<sup>14</sup> Discussion Paper, page 25.

If used in isolation it is difficult to see how this tool would provide any new capital or funds to allow a CCP to maintain its critical functions, and it may not be enough on its own to allow a CCP to access any additional liquid capital to cover losses. AMG does however believe that CCP equity should be at risk and capable of absorbing losses.

- (iii) *Transferring critical CCP operations (assets and certain liabilities) to a bridge entity and placing remnant CCP into liquidation/receivership.*

Whilst this is a useful possible mechanism for a resolution authority to use, this is most likely to be of use in practice following a non-default loss of a type which is sufficiently serious to result in resolution but which does not indicate a fundamental issue with the operation or risk management processes of the CCP. A default loss or a non-default loss caused by poor governance or risk management may not be solved by the transfer of critical operations to a bridge entity.

- (iv) *Dilution of existing shares as a result of raising new capital through conversion, issuance or transfer of new shares.*

Raising new capital is of course a useful mechanism for a resolution authority to have. Any dilution of existing shares and the mechanism for compensating market participants who have suffered losses must be considered together. The compensation mechanism should not restrict the ability of the resolution authority to raise new capital but any new capital must respect a priority claim awarded to those who have suffered losses.

- (d) *Section B outlines different options for the point in time or in the waterfall for imposing losses on equity. What are your views on these options? Are there any other possible options?*

The resolution authority should have flexibility to impose losses on CCP equity on a case-by-case basis responding to the facts of a given resolution, subject to always using CCP equity in resolution ahead of other creditors' assets. With respect to the Discussion Paper's suggestion that losses could be imposed on equity at "one or more specific fixed point(s) in the loss allocation waterfall..."<sup>15</sup>, AMG presumes this related to use of CCP equity prior to entry into resolution. As explained above, AMG supports the principle of more CCP equity being available as part of the loss allocation waterfall and being used at various different points of that waterfall. In particular, AMG supports more CCP equity being used prior to loss allocation mechanism such as VMGH and not after such mechanisms are used as the FSB suggests (see (iii) on page 23 of the Discussion Paper).

- (e) *What are your views on the potential constraints and challenges described in Section C? Are there other challenges or constraints to equity bearing loss? What are they and how should they be addressed?*

The FSB is correct to identify the potential constraints as being claims by shareholders and lack of powers to impose losses on equity in resolution. A resolution authority must (i) have the power to impose losses on equity in resolution and (ii) be able to use such powers in the knowledge that such action is effective as a matter of applicable insolvency laws and the contractual documentation under which the CCP operates. AMG believes the resolution authorities must be given such power. AMG believes legislation and regulation may be required to ensure that CCP equity can be used in resolution without significant risk of challenge. At the very least, CCPs should be required to undertake and make public legal and regulatory due diligence regarding the enforceability of using the loss allocation tools provided for in its rulebook as

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<sup>15</sup> Discussion Paper page 23.

well as tools that may be applied by a resolution authority. CCP's contractual arrangements (e.g. rulebooks) must be amended to reflect the use of CCP equity in resolution.

- (f) Section D outlines a number of policy considerations for the treatment of CCP equity in resolution. Are they appropriate and comprehensive? Would you suggest any additional policy considerations?

Generally speaking the policy considerations are appropriate and comprehensive.

We are pleased that the FSB has noted the “*impact on CCP management incentives to pursue sound risk management*”<sup>16</sup> as a policy consideration. AMG supports the view that limited or no exposure of CCP equity to losses is fundamentally wrong for the purposes of properly aligning incentives and reducing moral hazard. The FSB notes that “*reputational loss – and consequent loss of enterprise value*”<sup>17</sup> may serve as a strong incentive on the CCP to pursue adequate risk management. AMG does not view this as sufficient; end-users and consumers often do not have a choice of where to clear and in an industry with relatively few clearing houses and clearing members, efficiencies driven by netting and margin, and mandatory clearing driven by applicable regulation. It is not appropriate to rely on mere reputational effects to ensure adequate risk management – CCP equity must be exposed to losses to properly incentivize CCP's management and owners.

We are also pleased that the FSB has noted that the “*impact on clients*”<sup>18</sup> is a policy consideration. We support this for the reasons set out throughout this letter.

AMG observes that enhancing incentives to clear is not included as a policy consideration in the Discussion Paper. As noted at footnote 4 of this letter, AMG believes that recovery and resolution is a key consideration amongst end-users and consumers when choosing whether to clear their derivatives positions. All stakeholders should keep in mind the systemic benefits of clearing and the overarching aim of promoting financial stability for the real economy when considering CCP recovery and resolution. This should be added to the list of policy considerations in the Discussion Paper.

- (g) Does the treatment of CCP equity in resolution appear clear under existing arrangements in your jurisdiction or in relation to CCPs you are familiar with?

CCP rulebooks and local laws and regulations do not currently provide sufficient clarity or certainty with respect to the treatment of CCP equity in resolution. AMG encourages further work by all stakeholders (including regulatory authorities) to clarify the treatment of CCP equity in resolution, publish the results of this in a clear framework and ensure that CCP's rulebooks and resolution authorities' powers, policies and procedures are aligned with such a framework.

- (h) How could authorities reconcile the expectations that equity bears loss in resolution with the ‘no creditor worse off than liquidation’ safeguard?

Whilst the application of the ‘no creditor worse off than liquidation’ (“**NCWOL**”) to CCP equity is not clearly articulated in the Discussion Paper, we believe that the suggestions in the Discussion Paper (as discussed further in section 2 of this letter) regarding compensation mechanisms and greater exposure of

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<sup>16</sup> Discussion Paper page 24.

<sup>17</sup> Discussion Paper page 24.

<sup>18</sup> Discussion Paper page 24.

CCP equity in the loss allocation waterfall should generally reduce the likelihood that the use of CCP equity in resolution offends the NCWOL principle.

- (i) What, if anything, should change with respect to the treatment of CCP equity in resolution either to clarify existing arrangements or to potentially adjust the exposure of equity bearing loss in resolution (for example, setting out any additional measures to have equity bear loss in resolution in CCP rulebooks)?

Consistent with its position set out more fully in this letter, AMG advocates the following broad principles:

- CCP's skin-in-the-game should be increased and such skin-in-the-game should be able to be used at various points in the waterfall that properly align incentives of the CCP to properly risk manage and size default fund contributions.
- CCP equity should be used in resolution in priority to the assets of non-defaulting customers.
- To the extent non-defaulting customer assets are exposed to losses in resolution, a clear compensation mechanism must exist which allows such customer to have a priority claim against the CCP to fully recover its losses. Such a claim must be in a form that can be held by a wide universe of end-users and should not be limited to shares or other form ownership interest in the CCP. Against this, such a compensation mechanism must not affect the chances of the CCP returning to profitability or the ability for it to raise new capital.
- CCP rulebooks and the resolution authorities' powers should clearly set-out enforceable and clear processes for using CCP equity in resolution.

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AMG looks forward to participating in future discussions on financial resources to support CCP resolution and on the treatment of CCP equity in resolution and is available to discuss these comments. Should you have any questions, please contact Timothy W. Cameron at (202) 962-7447 or [tcameron@sifma.org](mailto:tcameron@sifma.org) or Jason Silverstein at (212) 313-1176 or [jsilverstein@sifma.org](mailto:jsilverstein@sifma.org).

Respectfully submitted,

/s/ Timothy W. Cameron  
Timothy W. Cameron, Esq.  
Managing Director  
Asset Management Group – Head  
Securities Industry and Financial Markets Association

/s/ Jason Silverstein  
Jason Silverstein, Esq.  
Asset Management Group – Managing Director and  
Associate General Counsel  
Securities Industry and Financial Markets Association