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**Financial Stability Board
FSB
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Switzerland**

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AFG's response to the FSB's discussion note on "Essential Aspects of CCP Resolution Planning"

The Association Française de la Gestion financière (AFG) welcomes the opportunity given by the FSB to express the French asset management's opinion on the Essential Aspects of CCP Resolution Planning

CCPs have a role more and more important in recent years vis-à-vis funds, due to the introduction of mandatory central clearing for standardised over-the-counter (OTC) derivatives with EMIR regulation.

Q1. Does this discussion note identify the relevant aspects of CCP resolution that are core to the design of effective resolution strategies? What other aspects, if any should authorities address?

AFG believes that authorities should pay more attention to the buy side. End investors are indirect clients of CCPs either spontaneously or by law. The incentive for them to clear through CCPs very much depends on the assurance they have that their assets will not be at any risk, even in case of default of a CCP. End clients do not sufficiently participate to discussions on the calibration of guarantee funds, capital, "skin in the game" and default waterfall of CCPs. Clearing members and CCPs are very close in the ecosystem and there is a risk that they take options that eventually will hurt end investors.

Incentive effects of resolution strategies

Q2. What is the impact on incentives of the different aspects of resolution outlined in this note for CCP stakeholders to support recovery and resolution processes and participate in central clearing in general? Are there other potential effects that have not been considered?

AFG believes that Board members should have deep knowledge of risks and assets under management. To this extent, involving clearing members (CMs) and end users within board functions is consistent with that approach. We believe that it is necessary to ensure however there is no conflict of interests between board members functions within the CCP and their own functions (i.e. participants from CMs and end users must be in capacity to exert independent judgment from their own organization).

As general rules:

- The independence of risk management functions from investment functions shall be ensured;
- While within financial institutions investment is first line of defense, risk is second line of defense and audit third line of defense. With respect to CCP, business specificity is that risk management is the key function and purpose of the CCP. Risk management functions shall be considered to be the first line of defense in that respect. Consequently, audit functions constitute a crucial second line of defense in CCP specific case. As such they must be strengthened and made fully independent (for instance through direct CEO reporting line).

Timing of entry into resolution

Q3. What are the appropriate factors for determining timing of entry into resolution? How might a presumptive timing of entry (or range of timing), if any, be defined in light of the criteria set out in the FMI Annex to the Key Attributes? If defined, should the presumptive timing of entry be communicated to the CCP and its participants?

Prescribability offers more certainty, management of exposure towards the CCP would be easier. If flexibility is required, exposure assessment shall be made conservatively by investors according to the worst case scenario. In any cases tools shall be known in advance to allow for measurement and management of exposures.

Adequacy of financial resources in resolution

Q4. Should CCPs be required to hold any additional pre-funded resources for resolution, or otherwise adopt measures to ensure that there are sufficient resources committed or reserved for resolution? If yes, what form should they take and how should they be funded?

AFG considers that cash calls may affect incentives for risk management and create liquidity and procyclicality risk.

Cash calls cannot be supported by all participants. In particular indirect participants may not manage liquidity risks properly (non-regulated entities, corporates with no liquidity planning...). Imposing cash calls to all end users indifferently would most probably generate systemic risk. If used as a resolution tool, regulators need to ensure that cash calls would be supported by liquidity regulated entities such as CMs and not indirect participants with very diversified profiles.

Q5. How should the appropriate quantum of any additional CCP resources be determined? In sizing the appropriate quantum, what factors and considerations should be taken into account? Do your answers vary for default and non-default losses?

AFG considers that it is crucial that pre-funded resources are sufficient to avoid resolution scenarios to the maximum extent.

To this end, calibration of stress test scenarios should mix credit & liquidity stress because the credit stress and liquidity stress are complementary.

We consider that it is necessary:

- to incorporate focus on gross to net risks born by market participants (c.f. ESRB report of September 2016 “Shedding light on dark markets: First insights from the new EU-wide OTC derivatives dataset”, dealers have a net to gross ratio of 0.20%, banks of 3M vs insurance & pension of 40%). Focus on management of very large portfolios with no net exposure could be a primary factor of risk and needs to be addressed in addition to mark to market sensitivities
- to have public disclosures & stress minimal requirements standardization

Q6. Should resolution funds external to the CCP be relied upon? If so, how should such funding arrangements be structured so as to minimise the risk of moral hazard, including for CCPs with significant cross-border participation? Where these are pre-funded, how should the target size be determined and which entities should be required to contribute?

Tools to return to a matched book

Q7. What factors should the resolution authority consider in choosing and exercising tools to return the CCP to a matched book? Is one (or more) of the tools for restoring a matched book preferable over others and if so, why?

In line with general principle of ensuring that no participant has interest to arbitrage between recovery and resolution. Tools should enable all stakeholders to assess their risks and manage them, as such they should all be disclosed ex-ante.

As end clients of CCPs, AFG’s members do not favor the forced allocation or tier up of contracts. It would put their portfolios, and ultimately their client investors, in a position where they might be exposed when thinking that they are hedged. This type of uncertainty creates non manageable risk.

What is of importance for them is to be able to rapidly identify which the consequences of a recovery procedure are (and not might be) for their portfolios. Risk management relies on exact data and cannot suffer uncertainty on exposures. And asset management is largely a question of risk management.

Q8. Should any tools for restoring a matched book only be exercisable by resolution authorities? If so, which tools and subject to what conditions?

Allocation of losses in resolution

Q9. What are in your view effective tools for allocating default and non-default losses and what are the pros and cons of these tools? Should initial margin haircutting be considered as a tool for the allocation of losses in resolution? Is one or more of the tools preferable over others? What are your views on the use of tools to restore a matched book as a means of loss allocation?

The initial margins are calibrated to cover own default risk not that of other participants and need to be reconstituted on the next days. The uncertainty about what the participants post, create liquidity risks and procyclicality risks on the participants

We strongly believe that IM haircutting should be fully taken off the table. CCP have unilateral ability to increase IMs in an unlimited way. IM haircutting risk would be neither measurable nor manageable for participants. CCP recovery and resolution tools should not disincentive clearing over bilateral transactions. Under bilateral transactions, IMs will mandatorily be protected through pledges and custodian agreements under EMIR. Haircutting of IMs on cleared transactions would strongly disadvantage clearing over bilateral OTC.

Similarly AFG considers that VMs haircutting may create very strong misalignment of interests if not implemented properly.

Participants having gains are not and must not be considered better off than those bearing losses. Derivative instruments are mainly used for hedging purposes with hedging gains compensating underlying loss and vice versa. Haircutting gains must not be seen as being neutral for participants as it leads to temporarily unhedged positions.

AFG believe that VMGH should never be used as a recovery tool and should be avoided as a resolution tool as it also creates procyclicality risks. Market participants would that may be subject to VMGH will seek to unwind their position in a disorderly manner to avoid losses which may negatively impact the market.

To the extent resolution authorities would retain VMGH as a resolution tool we urge them to use it as a last resort tool only and subject to conditions. In particular, there is a necessity to create an alignment of interest between all participants throughout recovery and resolution process to avoid arbitrages. AFG considers that clearing members involved in the liquidation process of the CCP should retain part of VMGH losses of their clients.

VM gains haircutting are only measurable and controllable to the extent they are capped or limited in time to allow for assessment of gap risk and potential exposure. VM gains haircutting must be limited.

There is a final general comment we would like to express with reference to loss allocation. Since shareholders and members are to suffer losses it is for end clients of high importance to make sure that they will not tend to pass the cost onto them. Regulation should help end

investors to get such a confirmation and the regulation should provide that responsible entities cannot transfer their risk or losses onto clients.

Q10. Which, if any, loss allocation tools should be reserved for use by the resolution authority (rather than for application by a CCP in recovery)?

As mentioned above AFG believe that VMGH should never be used as a recovery tool and should be avoided as a resolution tool as it also creates procyclicality risks. Resolution authorities shall seek to ensure CCP dispose of sufficient pre-funded resources through default fund contributions and skin in the gain.

Q11. How much flexibility regarding the allocation of losses is needed to enable resolution authorities to minimise risks to financial stability? For example, to what extent should a resolution authority be permitted to deviate from the principle of pari passu treatment of creditors within the same class, notably different clearing members in resolution? What would be the implications of a resolution strategy based primarily or solely on a fixed order of loss allocation in resolution set out in CCP rules vs. a resolution strategy that confers discretion to the resolution authority to allocate losses in resolution differently to CCP rules?

Deviating from the pari passu treatment of creditors would be very detrimental as it would affect market confidence in the CCPs. Uncertain treatment of creditors would rush them out of the CCP in stress scenarios which could further weaken the CCP. As already mentioned above, all tools available to the resolution authorities should be known in advance by market participants to allow them measure and manage their potential exposures to the CCP.

Q12. What are your views on the potential benefits or drawbacks of requiring CCPs to set out in their rules for both default and non-default losses:

- (i) The preferred approach of the resolution authority to allocating losses;**
- (ii) An option for, or ways in which, the resolution authorities might vary the timing or order of application of the loss allocation tools set out in the rules?**

For a fixed size of default fund, CCP contributions to losses is a matter of allocation of losses between CCP & CMs. CCP & CMs capital should (in theory) be remunerated similarly. Consequently there would be no specific incentive to allocate to one or the other from a client perspective.

If CCP contributions not designed to amortize losses, they must be calibrated in sufficient amount to represent a strong incentive function

Non-default losses

Q13. How should non-default losses be allocated in resolution, and should allocation of non-default losses be written into the rules of the CCP?

Recovery & resolution tools should not disincentivize CCP risk management through losses transfers.

Q14. Aside from loss allocation, are there other aspects in which resolution in non-default scenarios should differ from member default scenarios?

Capital requirement of CCPs should be calibrated to cover non default losses, non-default losses are part of general CCP business

CCP is supposed to be a pass through between market participants. As such, market participants should not be affected by CCP business activity. AFG believe that business losses should be borne by shareholders exclusively. Regulatory capital requirement, measurement & structure (tiering...) should be calibrated to withstand CCP business risk

Clearing agreement negotiation context:

- Clearing members are asking for indemnity provisions to cover non default losses risks
- Need to ensure within recovery and resolution process that allocation of losses are legally binding to CCPs, clearing members and end users and that losses cannot be transferred back to end users via bilateral contractual clearing agreements through indemnity provisions
- More generally, legally binding allocation of losses should be to be considered the whole recovery and resolution process to ensure permanent alignment of interests between stakeholders (i.e. should not be left to bilateral contractual agreement between clearing members and clients)

To the extent non default losses were allocated to other market participants, they should be granted equity shares or claims with preferential rights to recover such losses from CCP future profits

Application of the “no creditor worse off” (NCWO) safeguard

Q15. What is the appropriate NCWO counterfactual for a resolution scenario involving default losses? Is it the allocation of losses according to the CCP’s rules and tear-up of all the contracts in the affected clearing service(s) or liquidation in insolvency at the time of entry into resolution, or another counterfactual? What assumptions, for example as to timing and pricing or the re-establishment of the CCP’s matched book, will need to be made to determine the losses under the counterfactual?

Q16. What is the appropriate NCWO counterfactual for a resolution scenario involving non- default losses? Is it the liquidation of the CCP under the applicable insolvency regime, assuming the prior application of any relevant loss allocation arrangements for non-default losses that exist under the CCP’s rules or another counterfactual?

Q17. How should the counterfactual be determined in cases that involve both default losses and non-default losses?

Equity exchange in resolution

Q18. Should CCP owners' equity be written down fully beyond the committed layer of capital irrespective of whether caused by default or non-default events?

Q19. Should new equity or other instruments of ownership be awarded to those clearing participants and other creditors who absorb losses in resolution?

Clearing participants should be granted equity shares or claims with preferential rights to recover such losses from CCP future profits. Indeed, in situation of resolution resulting from members defaults, the CCP itself would hold a claim against defaulting members and should recover through time part of the losses.

Cross-border cooperation

Q20. What are your views on the suggested standing composition of CMGs? Should resolution authorities consider inviting additional authorities to the CMG on an ad-hoc basis where this may be appropriate?

Q21. What should be the nature of engagement with authorities in jurisdictions where the CCP is considered systemically important, for the purpose of resolution planning and during resolution implementation?

Q22. Should CCP resolution authorities be required to disclose basic information about their resolution strategies to enhance transparency and cross-border enforceability? If so, what types of information could be meaningfully disclosed without restricting the resolution authority's room for manoeuvre?

Our opinion is that resolution authorities are bound by the internal rules of the CCP that are available to the public. In that respect it might be consistent to include the resolution authority in the process of agreement of a CCP. But internal rules do not go as far as describing resolution or recovery strategies. Though, they strictly define the process for losses allocation through their default waterfall.

AFG considers that the resolution authority should limit its communication to a couple of general principles:

- Its action aims at ensuring continuity of central clearing considered as a critical function for the market
- Its decisions are deemed to best serve the common interest of all market participants;
- It shall be bound by official rules of the CCP such as the process to allocate losses according to the default waterfall and will not deviate from them;
- It keeps some flexibility in the usage of instruments and timing;
- It continuously monitors the advantage of switching from recovery to resolution in order to move before it becomes too late.

Cross-border effectiveness of resolution actions

Q23. Does this section of the note identify the relevant CCP-specific aspects of crossborder effectiveness of resolution actions? Which other aspects, if any, should also be considered?

Q24. What should be the role, if any, of the suspension of clearing mandates in a CCP resolution and how should this be executed in a cross-border context?

AFG supports the idea that a coordinated suspension of mandatory central clearing is a very powerful tool to maintain market activities and lower the risk of spreading anxiety and volatility. Being able to trade on a bilateral way will allow, first, to continue acting on the market as usual, second, for time to prepare a transfer from one clearing member to another or from CCP to another without undue pressure. It also reduces the cross margining between CCPs, hence, the systemic risk of cross default.

If you need any further information, please don't hesitate: to contact Eric Sidot (e.sidot@afg.asso.fr), or myself (e.pagniez@afg.asso.fr).

Sincerely Yours,
Eric Pagniez