EUROPEAN PRINCIPAL TRADERS ASSOCIATION

May 2017

FIA EPTA position on the proposed Regulation on the Framework for Recovery and Resolution of CCPs

On 28 November 2016 the European Commission published a legislative proposal on a framework for recovery and resolution for central counterparties (CCP RR). The proposal aims to incorporate the elements of international guidelines on CCP recovery and resolution developed by the Financial Services Board (FSB), the Committee on Payment and Market Infrastructures (CPMI) and the International Organisation of Securities Commissions (IOSCO).

As end users of clearing services, FIA EPTA members strongly support the European Commission's objectives to ensure that both CCPs and regulators have effective tools available to mitigate the systemic risks that would emanate from a potential failure of a CCP. However, we are concerned about the detrimental impact that the inclusion of the Variation Margin Gains Haircutting (VMGH) tool will have on market participants with hedged positions in exchange traded derivatives (ETDs) which are subject to variation margin requirements. In particular, there is a grave risk for market makers who rely on the futures markets to hedge the risks associated with this activity.

This position paper provides information about FIA EPTA, the role of our member firms as end users in the cleared, on-venue markets and the implications of VMGH. We believe that in order to mitigate the negative impact of VMGH and to preserve financial stability in the event of a CCP default, significant restrictions need to be put in place regarding the use of this tool in both recovery and resolution. Attached in the Annex are proposed amendments to the CCP RR proposal that in our opinion will help to achieve this outcome.

1. About FIA EPTA

This position paper represents the views of the FIA European Principal Traders Association (FIA EPTA) on the Draft Regulation on Recovery and Resolution of CCPs [COM(2016) 856 final] (**CCP RR**). FIA EPTA is comprised of 28 principal trading firms (**PTFs**) that deal on own account in a wide range of financial instruments traded on trading venues across the Union. Collectively, FIA EPTA members are an important source of liquidity for trading venues and end-investors, allowing those who use the capital markets to buy or sell financial instruments efficiently and at low cost, thus contributing to the overall quality of European capital markets.

FIA EPTA members trade mainly in exchange traded derivatives (**ETDs**) which are, by definition, centrally cleared. PTFs use General Clearing Members (**GCMs**) in order to access clearing and settlement services. Consequently, as end users of clearing services, FIA EPTA members would be significantly negatively impacted by any default of a CCP or GCM. Therefore, we welcome the Commission's legislative initiative to set up a framework for the recovery and resolution of CCPs.

2. General remarks

We generally support the proposed recovery and resolution tools available to CCPs and resolution authorities. However, we believe that the proposed framework needs further fine-tuning in order to take into account and address the possible negative consequences of implementing specific recovery or resolution tools.

It should be borne in mind that the default of a CCP would also have a devastating effect on the trading venues relying on the CCP's services. Thus preserving the smooth functioning of trading venues and of the markets in general should be an important principle of CCP RR.

FIA EPTA members agree that all market participants that operate in, and benefit from, a centrally cleared trading environment have an interest in an effective recovery or resolution process, should such a crisis scenario materialise. However, CCP RR should deliver balanced outcomes for all participants in the clearing chain by providing maximum transparency and predictability while maintaining sufficient flexibility. We believe that tailor-made recovery and resolution plans should be a part of all CCP rulebooks and should be subject to regular review. We support the Commission's proposals in this area.

Ultimately, we consider the prevention of a CCP default to be the overarching goal. For this reason the development of a robust CCP RR framework should go hand-in-hand with further improvements to the CCP default waterfall as part of the review of Regulation (EU) No 348/2012 (**EMIR**) ("**EMIR Review**") to increase the robustness of CCPs and their efficiency in absorbing default or non-default losses. Thus, we strongly support close coordination of these two policy files, so as lower the probability of ever having to apply CCP recovery or resolution tools.

3. Specific concerns

FIA EPTA members have identified specific concerns about the current drafting of the Commission's proposal for a CPP RR Regulation as outlined below.

Variation margin gains haircutting (VMGH)

We note the provisions of Article 30 CCP RR proposal that set out the specifications of variation margin gains haircutting (**VMGH**) as a resolution tool. We also note that Article 9 and Section A of the Annex to the CCP RR proposal leave significant discretion to CCPs in respect to drawing up their recovery plans to include, amongst others, VMGH as a recovery tool. We are concerned that none of these provisions places any conditions on the use of the VMGH tool. Given the procyclical financial stability risks that the application of VMGH may trigger, we believe setting such conditions are absolutely necessary to preserve, to the greatest extent possible, the smooth functioning of markets and financial stability in a crisis scenario of a (potential) CCP default. We provide further detail on our concerns with the VMGH tool below.

Impact of VMGH on market liquidity

For market making firms such as PTFs, variation margin gains will normally be offset by losses, in variation margin or otherwise, on positions in other instruments which are often cleared at different CCPs due to a lack of interoperability. This will be true especially for the correlated spread strategies and risk management hedges that are essential for implementing liquidity provision strategies.

If the risk of a CCP default were ever to materialise, this would likely be at a moment when financial markets experience severe stress. Typically, there would be both high volumes and high market volatility which would cause large variation margin 'gains' and 'losses' on futures positions. If VMGH would be applied, market makers may see one side of their trading book (i.e., the profitable side) being 'haircut' while the losing side remains intact. In extreme cases, it is possible that the haircutting of market making firms' profitable positions could be so substantial as to leave them with insufficient capital to cover the corresponding losses which might then cause their insolvency. This would create an unbalanced outcome which would clearly be contrary to the 'No Creditor Worse Off' (**NCWO**) principle as specified in Article 60 as well as to the principles expressed in Recital 23. Further, the default of multiple large market making firms at the same time could subsequently bring down one or more GCMs who had guaranteed these market making firms' positions. This in turn could lead to further and/or more severe CCP defaults.

It should be noted that as soon as VMGH would be applied, the market in the affected products (futures) is likely to suffer a significant reduction in liquidity, with market makers and other market participants being likely to withdraw from the market. Especially for market participants with two-sided positions, such as market makers, this is because continuing to trade these products will be a lose-lose scenario: either their trades will be loss making anyway, or these will be profitable but the profits will be 'haircut'. In either situation firms will be punished for having an open position in the market and can be expected to refrain from having these. As VMGH could cause trading in the affected products to come mostly to a standstill, applying VMGH more than once while possible in theory would most likely generate very little additional moneys as market participants could be expected to close out their inventories as quickly as possible to avoid additional potential haircuts. Market participants, including market makers, can be expected to only be returning to the market if they are confident that no further haircuts will be applied. Hence, in order to provide certainty to market participants and prevent further procyclical contagion effects, FIA EPTA considers that it should be clarified that VMGH should only be used once and for a limited time only, not exceeding one business day.

In situations of such market turbulence the demand for liquidity provision by market making firms will be high. However, if market making firms start to suspect that a CCP may be in trouble these firms will, for prudential reasons, likely not only cease providing liquidity on the trading venues connected to that CCP but also liquidate their existing positions. The fact that the CCP may potentially apply VMGH on firms' outstanding positions can be expected to aggravate these prudential concerns and lead to earlier and more comprehensive risk reductions which will further aggravate the liquidity crunch. The consequent low levels of liquidity in turbulent markets are likely to lead to extreme price movements (so-called "flash crashes") and volatility which will not then be dampened by market makers as these will have largely left the market, in particular if the application of VMGH would appear to be a realistic possibility.

The prospect of the application of VMGH is also likely to cause extreme price distortions as correlations between instruments (e.g., between futures and exchange traded funds (**ETFs**)) would break down as a result of futures markets becoming less liquid, leading to incomplete price discovery and market makers being unable to support the ETF creation and redemption process, which relies on risk hedging in the futures market. Similarly, for equity option markets, market makers need to rely on the futures markets to hedge their exposures.

Impact of VMGH on the auction process

The auction process is a key element in the functioning of the default waterfall as well as in any recovery scenario. In the auction, the CCP 'sells' the portfolios of the defaulting clearing member(s) to market participants. In a VMGH scenario market participants would be looking to reduce the size of their position inventory, not add to it. Market participants bidding on portfolios can be expected to take into account the possibility that a haircut may be applied in the future to any variation margin gains they may receive in connection with the acquired portfolio and will adjust their bid price accordingly.

In summary, VMGH may have a chilling effect on participants' willingness to participate in the auction process. This is expected to result in fewer participants taking part in the auction, lower bids by auction participants as they need to compensate for the additional risk associated with bidding, and ultimately a reduced likelihood of successfully re-establishing a matched book. Moreover, were VMGH to be applied to only specific categories of CCP members or products then this would reduce the probability of success of the auction even further as it could result in a situation where the portfolios which are to be auctioned do not meet the profile of those who are bidding.

Portability of customer portfolios

In case of a GCM default a smooth transfer of the client portfolios to another GCM is of utmost importance. The same is true, with greater urgency, in a CCP recovery or resolution scenario. We are concerned that currently legal obstacles in national (insolvency) laws stand in the way of ensuring the effective portability of client portfolios and related collateral. FIA EPTA members are hopeful that the EMIR Review process will result in the introduction of an obligation on Member States to adjust national insolvency laws to allow for smooth portability.

Interplay between CCP RR and EMIR, MiFIR

MiFIR introduces pre- and post-trade transparency requirements for OTC derivatives as well as a trading obligation for a subset of centrally cleared OTC derivatives. To ensure that market participants are willing to bid in a CCP auction, whereby they will be required to assume very large, unhedged positions, CCP RR should clarify that the MiFIR transparency and trading obligations are dis-applied for instruments that are involved in a CCP auction.

4. Proposed amendments mitigating the impact of VMGH[1]

In light of the above, FIA EPTA members are of the opinion that VMGH should be a tool subject to clearly defined restrictions that take into account the risks associated with VMGH. In particular we propose that:

- VMGH should only be used as a tool of last resort;
- VMGH should only to be used in the scenario of a GCM default and not in other situations;
- VMGH should be only used once and for a short period of time, not exceeding one business day;
- VMGH should be applied across the entire product suite and to all GCMs and their clients, with no discretion;
- If ever applied in practice, VMGH should reduce, but not fully wipe out, the variation margin due to clearing participants of a CCP.
- VMGH should only be allowed or used by the resolution authority subject to a comprehensive pre-application assessment of the systemic contagion effects on GCMs, their clients and connected CCPs and trading venues.

In light of the prospective negative implications of its application in recovery, FIA EPTA members believe that restricting the use of VMGH to resolution only would be justified. At a minimum, and only in a situation where co-legislators would allow the use of the VMGH tool in recovery, we are of the opinion such use by CCPs should be subject to strict conditions, including a pre-application assessment and approval by a resolution authority.

In order to prevent the undue procyclical transfer of systemic risk FIA EPTA considers that competent authorities, resolution authorities and ESMA should take into account the impact on trading venues (as defined in point 24 of Article 4(1) of Directive 2014/65/EU) when making decisions and taking action pursuant to this Regulation, and in particular as regards the potential application of any recovery and resolution tools.

In the Annex we include proposed amendments to CCP RR proposal and their justification. FIA EPTA members remain at your disposal to discuss any of the elements of this position paper and provide additional input as required.

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[1] These proposed amendments reflect the view of FIA EPTA members. Some of FIA's broader membership believe VMGH is a tool that should be available to CCPs in recovery. Further, some FIA members do not believe the use of VMGH should be limited to a single use, and believe there are scenarios where the use of an additional limited number of rounds of VMGH could be appropriate. All FIA members believe that VMGH should be used over a minimal time period and must not be used for anything other than allocation of a finite quantum of losses.

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Annex – Proposed amendments

Restriction of use of VMGH in recovery

Article 9 – Recovery plans	**Proposed amendment**
[…] 9. Recovery plans shall be considered as part of the operating rules of CCPs and CCPs shall ensure that the measures set out in the recovery plans are enforceable at all times.	[…] 9. Recovery plans shall be considered as part of the operating rules of CCPs and CCPs shall ensure that the measures set out in the recovery plans are enforceable at all times, ***subject to restrictions applicable to specific recovery tools as described in Section A of the Annex.***
Justification Variation Margins Gains Haircutting (VMGH) is used as recovery tool by some CCPs. While FIA EPTA supports that CCPs should have flexibility in drawing up their recovery plans, we are of the opinion that VMGH should be a recovery tool of last resort only. If applied with no restrictions in the event of a CCP default, VMGH will have detrimental impact on the clients of GCMs and it would create procyclical effects. VMGH should be used only once and for a very short time only, i.e. not exceeding one business day and only in the scenario of a GCM default.	
Annex – Section A **Requirements for recovery plans**	**Proposed amendment**
[…] 2. The recovery plan shall include the following items: […] (4) a comprehensive range of capital, loss allocation and liquidity actions required to maintain or restore the viability and financial position of the CCP including to restore its matched book and capital, and replenish pre-funded resources which are necessary for the CCP to maintain its viability as a going concern and to continue providing its critical services in accordance with Article 1(2) of Commission Delegated Regulation (EU) No 152/2013 and Articles 32(2) and 32(3) of Commission Delegated Regulation (EU) No 153/2013;	[…] 2. The recovery plan shall include the following items: […] (4) a comprehensive range of capital, loss allocation and liquidity actions required to maintain or restore the viability and financial position of the CCP including to restore its matched book and capital, and replenish pre-funded resources which are necessary for the CCP to maintain its viability as a going concern and to continue providing its critical services in accordance with Article 1(2) of Commission Delegated Regulation (EU) No 152/2013 and Articles 32(2) and 32(3) of Commission Delegated Regulation (EU) No 153/2013;

(5) appropriate conditions and procedures to ensure the timely implementation of recovery actions, as well as a wide range of recovery options, including an estimation of the timeframe for executing each material aspect of the plan; […]	(5) appropriate conditions and procedures to ensure the timely implementation of recovery actions, as well as a wide range of recovery options, including an estimation of the timeframe for executing each material aspect of the plan; […] ***3 (new). Notwithstanding provisions of paragraph 2(4) and (5), the use of Variation Margins Gains Haircutting in recovery plans may be considered only after all default waterfall sources are fully depleted. In order to apply Variation Margins Gains Haircutting, the CCP shall seek approval from the resolution authority.*** ***The resolution authority may allow Variation Margins Gains Haircutting under the following conditions:*** ***i. The loss allocation tool referred to in Article 30 shall only be used following the default of one or more clearing members;*** ***ii. The reduction in payment obligations shall be applied to the broadest scope of clearing members and products as possible;*** ***iii. The application shall extend to the maximum of one business day; and,*** ***iv. The application shall only be used once.***

Restriction of use of VMGH in resolution

Article 30 – Reduction of the value of any gains payable by the CCP to non-defaulting clearing members	**Proposed amendment**

1. The resolution authority may reduce the value of the CCP's payment obligations to non-defaulting clearing members where those obligations arise from gains due in accordance with the CCP's processes for paying variation margin or an economically identical payment. […]	1. The resolution authority may reduce the value of the CCP's payment obligations to non-defaulting clearing members where those obligations arise from gains due in accordance with the CCP's processes for paying variation margin or an economically identical payment. ***1a (new). The resolution authority may only use a reduction in payment obligations, as defined in paragraph 1, only after all default waterfall sources are fully depleted and under the following conditions:*** ***i. The loss allocation tool referred to in Article 30 shall only be used following the default of one or more clearing members;*** ***ii. The reduction in payment obligations shall be applied to the positions of all non-defaulting clearing members and to all financial instruments cleared by a CCP in resolution;*** ***iii. The application shall extend to the maximum of one business day; and,*** ***iv. The application shall only be used once.***
Article 48 -- General powers (resolution)	**Proposed amendment**
1. The resolution authority shall have all the powers necessary to use the resolution tools effectively, including all the following powers: […] (n) the power to reduce, including to reduce to zero, the amount of variation margin due to a clearing participant of a CCP under resolution;	2. The resolution authority shall have all the powers necessary to use the resolution tools effectively, including all the following powers: […] (n) the power to reduce~~***, including to reduce to zero,***~~ the amount of variation margin due to a clearing participant of a CCP under resolution;
Justification Variation Margins Gains Haircutting (VMGH) is used as resolution tool by some CCPs. We are of the opinion that VMGH should be a tool of very last resort. If applied with no restrictions in the event of a CCP default, VMGH will have detrimental impact on the clients of GCMs and it would create procyclical effects. VMGH should be	

used only once and for a very short time only, i.e. not exceeding one business day and only in the scenario of a GCM default. Finally, we consider a potential total reduction to zero of variation margin to be in conflict with the no creditor worse off (**NCWO**) principle.

Preventing undue disruption of orderly trading on trading venues

Article 7 – General principles regarding decision-making	**Proposed amendment**
Competent authorities, resolution authorities and ESMA shall take account of all the following principles when making decisions and taking action pursuant to this Regulation: (a) that the proportionality of any decision or action in relation to an individual CCP is ensured, taking into account at least the following factors: […] v) the CCP's interconnectedness with other financial market infrastructures, other financial institutions and with the financial system in general; […] (b) that the imperatives of efficacy of decision-making and of keeping costs as low as possible when taking early intervention or resolution action are observed; […] (h) that any obligation under this Regulation to consult an authority before any decision or action is taken implies at least an obligation to consult on those elements of the proposed decision or action which have or which are likely to have: (i) an effect on the clearing members, clients or linked FMIs;	Competent authorities, resolution authorities and ESMA shall take account of all the following principles when making decisions and taking action pursuant to this Regulation: (a) that the proportionality of any decision or action in relation to an individual CCP is ensured, taking into account at least the following factors: […] v) the CCP's interconnectedness with other financial market infrastructures including ***trading venues,*** other financial institutions and with the financial system in general; […] (b) that the imperatives of efficacy of decision-making and of keeping costs as low as possible ***while preventing the disruption of orderly trading on trading venues*** when taking early intervention or resolution action are observed; […] (h) that any obligation under this Regulation to consult an authority before any decision or action is taken implies at least an obligation to consult on those elements of the proposed decision or action which have or which are likely to have: (i) an effect on the clearing members, clients or linked FMIs ***including trading venues;***

Article 21 – Resolution objectives	Proposed amendments
1. When using the resolution tools and exercising the resolution powers, the resolution authority shall have regard to all the following resolution objectives and shall balance them as appropriate to the nature and circumstances of each case: […] (c) to avoid a significant adverse effect on the financial system, in particular by preventing contagion of financial distress between financial institutions and by maintaining market discipline;	1. When using the resolution tools and exercising the resolution powers, the resolution authority shall have regard to all the following resolution objectives and shall balance them as appropriate to the nature and circumstances of each case: […] (c) to avoid a significant adverse effect on the financial system, in particular by preventing contagion of financial distress between financial institutions and by maintaining market discipline ***while preventing the disruption of orderly trading on trading venues;***
Justification In order to prevent the undue procyclical transfer of systemic risk FIA EPTA considers that competent authorities, resolution authorities and ESMA should take into account the impact on trading venues (as defined in point 24 of Article 4(1) of Directive 2014/65/EU) when making decisions and taking action pursuant to this Regulation, and in particular as regards the potential application of any recovery and resolution tools.	