



27 July 2018

Via Electronic Submission

To:

**Steven Maijor
Chair, European Securities and Markets Authority**

**Olivier Guersent
Director-General for Financial Stability, Financial Services and Capital Markets Union, European Commission**

ESMA's request for clarification re margin requirements for public entities

Dear Mr. Guersent and Mr. Maijor,

FIA is the leading global trade organization for the futures, options, and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. This letter represents the views of those members of FIA who act as clearing members. Clearing members serve an important “first line of defence” role in the context of clearing by facilitating the collection of margin, guaranteeing customer positions and contributing to the CCP default fund.

We are grateful that ESMA has taken up the issue of whether CCPs should be able to exempt public entities from obligations to provide the CCPs with default fund contributions and initial margin. These requirements apply to all other clearing members. This is a practice that works against a key pillar of clearing (the mutualisation of risk) and has caused concern among clearing members, as such exemptions provide a “free ride” for such public entities at the expense of other clearing members.

FIA clearing members do not agree with these exemptions provided to public entities.

Default Fund Costs

Membership of CCPs by public entities without contributions to default funds may result in the costs of covering the risk introduced by the public entity being covered by all other clearing members in the form of higher default fund contributions.

A CCP's default fund must be sized in order to sufficiently cover the risk generated by all transactions: where the level of loss generated by a defaulter's transactions is higher than the default fund and initial margin posted by the defaulter(s), the remaining loss is covered by the mutualised default fund, into which all clearing members pay in. Where a public entity clearing member introduces trades and thus risk to the CCP but does not provide its own default fund contributions, the public entity's share of the default fund is likely to be covered by increased default fund contributions of all other clearing members. This is particularly impactful on smaller clearing members who find it difficult to bear such increased costs.

Even if a public entity is of such credit quality that it will never default, the public entity is introducing risk to the CCP by enabling other firms (typically of lower credit quality than a public entity that one considers incapable of default) to introduce their (opposing) side of the transaction to the CCP. These

increased default fund contributions are an up-front cost borne by other clearing members since default fund contributions are pre-funded.

Fairness to Other Clearing Members

Membership of CCPs by public entities without contributions to default funds amounts to those entities receiving the benefits of clearing without bearing any costs, which violates principles of fairness. By joining a CCP, the clearing members accept that they will ultimately be liable for mutualised tail risk in the case that another clearing member (or clearing members) defaults. In return for this risk, all members enjoy central clearing benefits, for instance reduced counterparty risk, operational efficiencies, central valuations and processing of variation margin, and often better prices compared to bilateral transactions as these benefits are often priced into quotes for cleared transactions. Should any clearing member not be required to pay into the default fund, this member is effectively reaping the benefits of participating in clearing, without participating in the corresponding mutualisation of risk.

One reason given for these public entities not paying into the default fund is that they are not allowed to participate in the default management process. However, default fund contributions are intended to cover losses following default on a mutualised basis; they are not primarily a charge in return for participation in auctions so we do not regard non-participation in auctions as a basis to be exempt from default fund contribution.

Risk Posed by Public Entities

The argument that initial margin from public entities is unnecessary because public entities pose no risk of default (due to their nature) is not a credible one from a risk management perspective. While a case could be made that some public entity clearing participants are extremely unlikely to ever become insolvent and/or unable to meet their payment obligations to a CCP, it is not a certainty that such entities will never choose to default. In any case, the low risk of some public entities should be reflected by the normal application of CCPs' risk management practices and margin calculations rather than a blanket exemption in respect of initial margin. In addition, some public entities are fully capable of becoming unable to meet their payment obligations, for example, entities which are not currency sovereigns. We note the BCBS discussion paper on "The regulatory treatment of sovereign exposures" published in December 2017, which emphasised the importance of genuine risk assessments of different sovereign entities (even between different types of sovereign entities such as central banks and governments.) This discussion paper analytically supports risk assessment of public entities, as with other clearing members, as opposed to blanket exemptions¹.

FIA clearing members believe that if public entities are to continue participating in clearing, they should do so without exemptions in respect of default fund contributions and initial margin.

Again, we appreciate that ESMA has brought up this issue for discussion and clarification. If you have queries or want to discuss further, we and our members are more than willing to make ourselves available.

¹ <https://www.bis.org/bcbs/publ/d425.pdf>

We look forward to engaging with ESMA on the matters discussed in this letter. Please contact Jacqueline Mesa, Senior Vice President of Global Policy at FIA, at +1 202-466-5460 if you have any questions.

Yours sincerely,

A handwritten signature in cursive script that reads "Walt L. Lukken".

Walt L. Lukken

President and Chief Executive Officer

Futures Industry Association