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28 September 2012

BlackRock Response to the CPSS-IOSCO Consultative Report on Recovery and Resolution of Financial Market Infrastructure (FMIs)

Dear Sirs,

BlackRock welcomes the opportunity to respond to the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) Consultative Report on Recovery and Resolution of Financial Market Infrastructure (FMIs).

BlackRock is a leader in investment management, risk management and advisory services for institutional and retail clients worldwide. At 30 June, 2012, BlackRock's AUM was $3.56 trillion (€2.74 trillion). BlackRock offers products that span the risk spectrum to meet clients' needs, including active, enhanced and index strategies across markets and asset classes. Products are offered in a variety of structures including separate accounts, mutual funds, iShares® (exchange-traded funds), and other pooled investment vehicles. BlackRock also offers risk management, advisory and enterprise investment system services to a broad base of institutional investors through BlackRock Solutions®.

Our client base ranges from sovereign wealth funds and official institutions to financial institutions, foundations, corporations, charities and pension funds. The mainstay of our client base is represented by pensioners and savers. BlackRock pays due regards of its clients' interests and it is from this perspective that we engage on all matters of public policy. BlackRock supports regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analyses, preserves consumer choice.

We have set out in this letter our views on resolution regimes for FMIs that are central counterparties (CCPs) as envisaged in the consultative report and summarise our views below.

BlackRock agrees that most CCPs are very likely to be systemically important. The failure of a CCP of any consequence in terms of size has the potential to be a catastrophic event, particularly as swap positions at a failing CCP will not be fungible with positions at any other CCP.

We are of the view that a regime which focuses on the rapid liquidation of open positions at the CCP is more appropriate than a regime which aims to enable the CCP to continue to provide services once it has reached the point where a resolution regime will be triggered. We do not believe that the latter would be in the best interests of clearing members, their clients or market stability for the reasons we explained on in our attached response. In our view, a rapid and complete winding-down of the failing CCP's positions and an orderly repayment of margin monies would achieve a greater level of financial stability than trying to ensure the continuity of clearing services.

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We appreciate the opportunity to address and comment on the issues raised by this consultation paper. We are prepared to assist CPSS and IOSCO in any way we can, and welcome continued dialogue on these important issues. Please contact any of the undersigned if you have comments or questions regarding BlackRock's views.

Yours faithfully,

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Recovery and resolution of financial market infrastructure (FMIs) – consultative report

1. BlackRock agrees that most CCPs are very likely to be systemically important. We would therefore agree that it is important to consider measures to address the potential failure of a CCP (however extreme such a situation may be).

2. However, we are not convinced that the features of a resolution regime outlined in the report are practical or likely to be in the best interests of clearing members, their clients or market stability. In particular, we do not agree that the focus of any resolution regime should necessarily be ensuring the continuity of services.

3. In order to achieve continuity it is envisaged that a resolution regime include the power to transfer positions and associated margin from the failing CCP to another existing CCP or a bridge CCP established by the resolution authority.

4. In our view such transfer is unrealistic. Indeed the report acknowledges the difficulty of transferring functions of some FMIs to alternative providers:

   "For some FMIs, however, there may be few (if any) alternative providers of its critical operations or services in the short run to which the operations can be sold. Even if an alternative provider does exist, there may be a number of practical issues that would prevent participants from being able to immediately transfer their assets, positions and activities."

5. We share the report's concerns regarding the viability of this resolution tool. Unless the transferee CCP already has relationships with the transferring clearing members and their clients and connections to the relevant markets for which it would be clearing positions, then it would not be possible to transfer positions of those clearing members nor for a transferee CCP to provide clearing services in relation to such markets.

6. Moreover, in relation to OTC derivatives which are subject to clearing, positions with one CCP will likely not be fungible with positions at another CCP since the product terms and rules will differ between CCPs. This is similar to how futures markets function today.

7. Also, in circumstances in which a significant CCP has failed and may be resolved, we are sceptical that another CCP could be found that was willing to assume all the positions of the failing CCP, and certainly not without extensive diligence. Current CCP risk management practices do not take into account additive risk transferred from another CCP. We are also doubtful that a bridge institution could be used for something as operationally complex as a CCP.

8. We are also concerned by the proposals relating to loss allocation (bail-in within resolution). These seem to envisage the allocation of losses to non-defaulting members through a margin haircut (essentially a power to write down the CCPs liability to return margin to clearing members) or through the ability to call for members to replenish the CCPs funds. If transactions on a CCP were at risk of a margin haircut that applied to client margin as well as clearing member margin, the potential allocation of losses to non-defaulting clients would make such a CCP highly unattractive and potential non-viable from a client perspective. Even where a margin haircut applied only to clearing member margin, the concept of imposing additional costs on clearing members above and beyond the default fund contributions and assessment rights such clearing members are already subject to would be problematic. The ability to impose such losses on non-defaulting clearing members could cause the sort of financial instability which central clearing is intended to reduce. The incremental, and potentially unlimited, liability associated with being a clearing member under such a regime would likely cause the regulators of such clearing members to impose additional capital or liquidity costs on the clearing members, which would be passed onto clients.

9. Where it has been determined that a CCP has failed or is likely to fail then in our view the best outcome for participants and the market generally is a very rapid liquidation of open positions at the CCP. With the exception of positions that a defaulting client holds through a defaulting clearing member, it is important to note that the CCP has a risk neutral matched book of outstanding

positions. The resolution authority could have the power to assume control of the CCP in order to terminate all outstanding open positions at a given price for each transaction (for example, the last day's closing price). There should be a rapid calculation of the close-out amounts due between the CCP and non-defaulting clearing members and non-defaulting clients, and the net amounts should be paid as promptly as possible. The sooner the close out of all open positions occurs, the less likely additional defaults would compound the problem.

10. The purpose of the rapid liquidation of positions would be to close-out the clearing business very quickly and to return margin provided by non-defaulting clearing members and non-defaulting clients with minimum market loss.. A rapid liquidation and return of margin would allow clearing members and their clients to establish replacement positions in the most efficient manner.

11. Trying to keep the failing CCP functioning pending a transfer to a new CCP or bridge CCP, or pending commencing a winding up, is likely to be very difficult and potentially destabilising creating systemic risk. Many clearing members are likely to want to terminate their clearing agreements and withdraw from the CCP. This termination of agreements (accompanied by the closure of the clearing member's positions at the CCP) is likely to exacerbate the failing position of the CCP and create further instability.

12. Ultimately, in our view, a rapid and complete winding-down of the failing CCP's positions and an orderly repayment of margin monies would achieve a greater level of financial stability than trying to ensure the continuity of clearing services.