



ES - n°4566-10/Div

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Paris, October 18, 2016

AFG's response to the IOSCO's consultative report on "Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI"

The Association Française de la Gestion financière (AFG) welcomes the opportunity given by the IOSCO to express the French asset management's opinion on the resilience and recovery of central counterparties (CCPs)

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

Please find hereafter our general comments:

I. Governance

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 are crucial as 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).

II. Stress testing

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

III. Coverage

AFG considers that cover 2 principle should be a minimum, but CCP could target higher level. The Cover 2 principle should be observed continuously. Public disclosure shall be made with respect to breaches with respect to the Cover 2 principle (not necessarily at the time of the breach, but through annual / semiannual or along with other public reportings).

IV. Margin

i. IM haircutting

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.

ii. Cash calls:

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.

iii. VM gains haircutting (VMGH):

AFG considers 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 gain 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. Resolution authorities should instead seek to ensure CCP dispose of sufficient pre-funded resources through default fund contributions and skin in the gain.

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 auction process of the CCP should retain part of VMGH losses of their clients. VMGH 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. VMGH must be limited.

V. CCP contributions losses

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 are not designed to amortize losses, they must be calibrated in sufficient amount to represent a strong incentive function.

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)

Eventually, 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.

VI. Recovery

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.

As end clients of CCPs, AFG's members do not favor the forced allocation or tier up of contracts as recovery or resolution tools. 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.

VII. Other considerations

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.

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.

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