EU proposal for a regulation on a framework for the recovery and resolution of central counterparties

BlackRock Prepared Remarks

- Thank you for inviting BlackRock to provide remarks on the proposed European legislation on the recovery and resolution of Central Counterparties.
- As an asset manager, BlackRock advises millions of European pensioners and savers on how to prudently plan for their financial future. We do this by offering investment solutions that incorporate a wide range of financial assets, including centrally cleared derivatives, such as interest rate and inflation linked swaps, which are typically used for hedging purposes.
- It is important to note that BlackRock acts as a 3rd party manager of the funds – it does not itself own these assets. BlackRock does not itself take risk to Central Counterparties (our clients bear this risk), but as a Fiduciary to our clients – Europe's pensioners and savers - we have a clear interest in fostering stable financial markets. To that end, BlackRock is supportive of central clearing and believes it ultimately helps reduce systemic risk.
- I sit here today as a risk management professional. I am part of BlackRock's Counterparty Credit Risk team, which sits within the Risk and Quantitative Analysis division. My job is done on a Fiduciary basis; I identify and mitigate credit risks on behalf of BlackRock's clients. My specific focus is on Central Counterparties and on a typical day, I am at my desk parsing through various disclosures to arrive at a credit view. This is no easy task, I assure you.

- While we are here today to speak about Recovery & Resolution, as a risk manager, I must ask lawmakers not to lose sight of the importance of the "third R", which is Resilience.
- A CCP that is subject to appropriate and diligent oversight, by market participants as well as regulators, should be better able to withstand the market disruptions it is designed for. Our collective goal should ultimately be to avoid Central Counterparties getting into trouble. This goal requires all of us to pay sufficient attention to a CCP's Resilience.
- To that end, we ask you to consider the following:

- CCP's have become systemically important and should be subject to a reasoned and defensible capital requirement. Current EU capital regulations, requiring a CCP to hold one year's worth of operating expenses as capital, and dedicate 25% of that to the waterfall, are not sufficiently rigorous for such important institutions.
    - CCP capital serves two distinct purposes:
        - First, to sufficiently absorb any non-default related business losses, such as those caused by operational missteps.
        - Second, with respect to default losses, to serve as both a loss absorption mechanism and to properly align a CCP management's interest with strong risk management.
    - Both forms of capital are important to ensure resilience, but neither is currently governed by a rigorous capital regime. Many industry participants feel that in general, CCPs' capital committed to the waterfall ("skin in the game") is too small, while most CCPs claim the amount is more than sufficient.
    - Who is right? I don't actually know the answer to that, because to my knowledge there hasn't been any real analytical rigor put to that question.
    - What is the optimal level of capital that aligns incentives while avoiding potential moral hazard on the part of market participants? What is the optimal amount of capital to protect against non-default losses? How should those risks be measured? We encourage ESMA to take a view on these questions.
- Ensuring CCP resilience requires an analytically sound capital framework.

- We also encourage policy makers to adopt more formal standards for CCP disclosure and introduce audit requirements to help ensure the accuracy of information released.
- In the interest of time I will not belabour this point and will simply point out that CCPs, who have been handed a virtual monopoly in many markets, and who have as a result become systemically important in many jurisdictions, have materially lower disclosure requirements than even the smallest public company.

Current disclosures lack formal standardization, contain little explanatory text and are not subject to an audit requirement.

- Ensuring CCP resilience requires transparent and comparable CCP disclosure.

- Thank you for indulging me on those comments and I will now focus more directly on today's agenda.
- We welcome the Commission's proposal on Recovery & Resolution. The legislation allows CCPs to develop recovery measures through their rulebook and affords authorities discretion in resolution.
- Of course I wouldn't be here today if we believed the legislation were complete. We believe it can be strengthened, particularly to enhance the protections afforded to end-investors, those pensioners and savers, who are often the same tax payers the legislation is supposed to protect.
- We believe it is important to distinguish between the owner/operators of the clearing infrastructure – those who earn a return from providing the service – and the users of the clearing infrastructure – those who pay a fee for the service of risk mitigation. This distinction is very important when considering tools available to the CCP to recover its operations compared to tools available to a resolution authority to resolve a failed CCP.

- With respect to CCP recovery, we believe it is wrong to allow a CCP, which is usually a for-profit enterprise, to take its customer's money after it has failed in the provision of its main service: credit risk mitigation.
- That is exactly what "variation margin gains haircutting" does – it takes money that belongs to market participants, that belongs to our clients, and uses it to cover losses that are the result of a CCP's failed risk management. This is why it is one of our key concerns.
- I will summarise our concerns by making reference to three c's – control, capping and compensation – which we believe would enhance end-investor protections.

    - The first c – control. Once committed resources (and any other private sources of funding) are exhausted, only resolution authorities should

control loss allocation in recovery and resolution. This would be an important addition from the perspective of financial stability since it is only the competent authority, and not the CCP, that could foresee the macro-economic implications of its actions across all parts of the financial ecosystem, including the real economy. Giving the authorities sole discretion to oversee and trigger loss allocation would give the end-investor - who has no say in the negotiations between the CCP and its clearing members on any aspect of the rulebook - additional confidence to use central clearing.

- The second c – capping. If the competent authority determines variation margin gains haircutting has to be used as a loss allocation tool in the recovery process, it should be at the very end of the recovery process and tightly constrained to best protect the financial system and end-investors. For example, caps could be applied on the overall quantum of the haircut or on the number of days the haircut can be applied. Right now the potential liability that end-investors face from variation margin gains haircutting is open ended.
- The third c – compensation. All end-investor losses arising from recovery and/or resolution of CCPs should eventually be fully compensated by the CCP and/or its shareholders. End-investors must be given senior creditor status for any funds used in the recovery or resolution process. Thought should also be given to granting claims against future profits from a recovered CCP, whose recovery was ultimately financed by the end-users.

- Lastly, but importantly, we firmly believe that Initial Margin Haircutting should be explicitly ruled out of both recovery and resolution, given that its deployment would amplify systemic risk at a time of significant systemic fragility.

- Thank you for the opportunity to present these remarks. I look forward to any questions from Members.