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Dear Sir/ Madam

Consultation Paper on Central Counterparty Recovery – Uncovered Loss Allocation and Replenishment Tools for Clearing Participant Default

- 1. Introduction:** The International Swaps and Derivatives Association, Inc. (**ISDA**)¹ welcomes the opportunity to provide comments on the Australian Securities Exchange (**ASX**) consultation paper on the *Central Counterparty Recovery – Uncovered Loss Allocation and Replenishment Tools for Clearing Participant Default* (the **CP**) released on 2 October 2014.
- 2. Scope of this response:** In this response, we will address the issues regarding the recovery and continuity of a systemically significant or critical central counterparty (**CCP**) clearing service, the recovery tools in the CP and the proposed ASX Clear (Futures) straw man. As our focus is on the over-the-counter (**OTC**) derivatives market, our response will only address certain aspects of the CP. As the industry is still discussing the issues regarding the recovery and resolution of a CCP, this paper will not address the questions specified in the CP but aims to provide an overview of the recovery and resolution framework for a CCP. Individual members will have their own views on the CP, and may provide their comments to ASX independently.
- 3. Overview:** As you are aware, the Committee on Payment and Settlement Systems (**CPSS**) and the International Organization of Securities Commissions (**IOSCO**) (collectively known

¹ Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

as **CPSS-ISOCO**) developed the *Principles for Financial Market Infrastructures*² (**PFMIs**) to ensure a common base level of risk management across CCPs and countries. These principles were further supplemented by the Committee on Payments and Market Infrastructures (**CPMI**) and IOSCO (collectively known as **CPMI-IOSCO**) report on the *Recovery of Financial Market Infrastructures*³, which outlines a broad framework for recovery and offers a choice of recovery tools.

ISDA is very supportive of the guidance provided in the CPMI-IOSCO report. We commend ASX for its efforts to implement the guidance provided in the CPMI-IOSCO report. We strongly support the recovery and continuity of a systemically significant or critical CCP clearing service. We believe this would be less disruptive and likely to be less costly to the financial market as well as to market participants that utilize cleared derivatives contracts to manage and hedge their risk exposures. As such, recovery of a clearing service is generally preferable to its closure (clearing service termination), particularly in times of severe market stress. It is extremely important that any measures to prevent a foreseeable clearing member (**CM**) default are employed and that the CCP's default management strategy (**DMS**) incorporates recovery measures that are both comprehensive and effective.

Effective default management is predicated on the ability of a CCP to transfer the defaulted CM's clients to solvent CM(s) and re-establish a matched book at a cost that is within the defaulted CM's pre-funded default resources, i.e., its initial margin (**IM**) and its contribution to the default fund (**DF**). The recovery framework must also consider measures that could provide additional default resources where all pre-funded resources have been exhausted and measures to allocate losses, if necessary. The portfolio auction enables a CCP to re-establish a matched book and is usually part of the default management process (**DMP**) of a CCP. As explored in the CP, there are additional tools that may be considered if the auction is not successful in re-establishing a matched book. In the event no measures are effective in re-establishing a matched book, a CCP will need to consider the termination of the clearing service and/or its viability. It is at this point, that a resolution authority would evaluate whether or not to trigger resolution and whether resolution would be effective in restoring the viability of the clearing service. This is reflected in the guidance provided by the Financial Stability Board *Key Attributes of Effective Resolution Regimes for Financial Institutions* (**FSB KA**) which states that "entry into resolution should be possible, subject to determination by the relevant authorities, if the recovery plan and any rules and procedures for loss allocation have failed to return the FMI to viability or have not been implemented in a timely manner, or the relevant regulator, oversight, supervisory, or resolution authority determines that, even though the plan may not yet have been fully implemented or exhausted, recovery measures are not reasonably likely to return the FMI to viability or would otherwise be likely to compromise financial stability"⁴.

² <http://www.bis.org/cpmi/publ/d101a.pdf>, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012.

³ <http://www.bis.org/cpmi/publ/d121.pdf>, Committee on Payment and Settlement Systems and Board of the International Organization of Securities Commissions, *Recovery of Financial Market Infrastructures*, October 2014.

⁴ http://www.financialstabilityboard.org/publications/r_141015.pdf, Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, II-Annex 1, paragraph 2, Page 58, 15 October 2014.

- 4. Proposed Recovery Framework:** We propose a tailored recovery framework for the restoration of a CCP clearing service that has experienced a threat to its sustainability due to losses caused by a CM default (also known as **Default Losses**) and the tools to re-establish a matched book. The proposed recovery framework does not expand on other types of losses, in particular, losses related to liquidity shortfalls and non-Default Losses. We seek confirmation that ASX would cover such non-Default Losses with its own capital and no losses would be allocated to the clearing participants.
- (i) **Recovery measures:** These recovery measures should be available to the CCP: (a) portfolio auction of a defaulted CM's portfolio as part of the existing DMP; (b) consideration of alternative forms of contract tear-up to re-establish a matched book; (c) limited cash calls to solvent CMs to increase default resources; and (d) loss allocation mechanisms in the form of pro-rata reduction in unpaid payment obligations of the CCP (referred to as **PRO**). It is extremely important that cash calls to CMs are predefined, limited and quantifiable. Additionally, loss allocation tools should only be considered if they are clearly agreed upon and in place, and are economically viable for all categories of clearing participants.
 - (ii) **Transparency and timing:** These recovery measures should be clearly defined in the relevant clearing services' rulebooks to provide clearing participants the needed transparency, predictability and ex-ante certainty related to the maximum timeframe for the DMP before recovery tools are considered to have failed, the applicable legal construct and the source and utilization of resources. As recovery measures are incorporated into the DMP of a clearing service, recovery should occur within the specified time period.
 - (iii) **Appropriateness of utilizing recovery measures beyond the portfolio auction:** This decision should be based on an assessment of whether the clearing service is viable. Clearing service viability is based primarily on the effectiveness of the DMP in re-establishing a matched book whilst also maintaining sufficient default resources, i.e., fully funded IM, DF contributions and any 'skin in the game' (**SITG**). If default resources have been exhausted, additional recovery measures to increase them through cash calls or measures involving loss allocation to clearing participants (beyond that already provided for by the CMs' DF contributions) should only be considered if the DMP remains effective.
 - (iv) **Compensation for loss allocation:** The CCP should be obligated to fully compensate clearing participants, if recovery measures involve loss allocation to clearing participants.
 - (v) **Segregated clearing services:** If a CCP offers several clearing services (for example: a CCP provides clearing services for interest rate swaps (**IRS**) and credit default swaps (**CDS**)), each clearing service should be segregated and structured to be of limited recourse to the CCP (i.e. **Limited Recourse Clearing Service**).⁵ This allows for the mitigation of contagion across

⁵ The benefits of limited recourse clearing services are widely recognized and have been adopted already by some leading CCPs. There are numerous motivations to offer limited recourse clearing services, principle among them being that it allows for the *pseudo-resolution* of a single clearing service (i.e. clearing service termination). Thereby, where a clearing service has failed as a result of a default event, it can be terminated without placing the CCP legal entity itself into resolution and thus allowing other clearing services of the CCP to continue. Therefore, where a CCP offers limited recourse clearing

other clearing services of the CCP, allowing other clearing services to continue in the event of a single clearing service termination. This also focuses and strengthens the incentives of clearing participants to assist the CCP in the default management of each clearing service.

- (vi) **Failure to re-establish a matched book:** If the DMP of a clearing service has not been successful in re-establishing a matched book and all other alternatives to re-establish a matched book has failed or would not be effective, the sustainability of the clearing service is threatened and the alternative of *involuntary* continuation, such as forced allocation, is likely to only further exacerbate systemic risk. In such an instance, the CCP needs to consider the closure of the clearing service or clearing service termination. If the decision is for complete termination, it must be done in an orderly fashion that is predefined and transparent to all clearing participants.
- (vii) **Condition for entry into resolution:** If the DMP has failed to re-establish a matched book and thereby clearing service termination is dictated, it is likely that the resolution authority would be evaluating whether or not this is a trigger to place the CCP into resolution and whether resolution measures could be effective to restore the viability of the clearing service.

5. Proposed ASX Clear (Futures) Straw Man for Recovery and Resolution: The ASX Clear (Futures) straw man recovery proposal introduces additional recovery tools in addition to the auction process. We have provided comments for each of the recovery tools in the proposed ASX Clear (Futures) straw man for recovery and resolution.

- (i) **Emergency assessment:** As noted in paragraph 4(i), the emergency assessment/ cash calls to CMs should be predefined, limited and quantifiable. We seek clarity if there will be any changes to a CM's resignation timeframe with the introduction of the additional recovery tools as CMs should always have the choice, subject to the resignation timeframes published in the relevant clearing service rulebook, of whether they will continue participating in a CCP after a CM(s) default(s). Further, we seek clarity if a CM resigns prior to the emergency assessment commitment would the CM need to commit the emergency assessment if ASX calls for the emergency assessment within the resignation period.
- (ii) **Variation Margin Gains Haircutting (VMGH):** We are supportive of ASX adopting VMGH as a new recovery tool. ASX may wish to consider providing due compensation in the form of equity stake and senior claim in the books of ASX for clearing participants that are subject to the VMGH. We seek clarification on the reasoning behind the VMGH application whereby VMGH is only applied when VM outgoings on a day exceed the sum of VM incoming plus default resources plus 75% of assessments received instead of 100% of assessment received. Further we seek clarity that the timing for the VMGH will occur at the current time of settlement on each day.

services, we believe that references to 'CCP wind-down' and 'CCP resolution' should be interpreted as 'clearing service wind-down' and 'clearing service resolution' (i.e. clearing service termination).

(iii) **Partial Termination:** If the DMP of a clearing service has failed and the complete termination of the clearing service is dictated, a form of partial termination is preferable from the perspective of (a) systemic safety and (b) continuity of a clearing service, as long as it is compatible with the accounting and regulatory capital framework. It is critical that the requisite accounting criteria to net cleared derivatives is not frustrated. It may be possible to structure partial terminations in a manner such that it will not frustrate the requisite accounting criteria to net cleared derivatives for the purposes of financial statement and regulatory capital purposes if it is done on a pro-rata basis across *all* clearing participants who have a position opposite to those of the defaulted CM's positions; at the last settlement price of the position (i.e. prevailing market value) and; is used as a method to re-establish a matched book and not as a means of loss allocation. It should be noted that partial termination may unfairly impact a subset of clearing participants with impacted positions which will need to replace their positions and potentially suffer unpredictable and unreasonable replacement costs.

Partial termination could also be performed for a subset (or product type within) of the clearing service as long as it meets the conditions above. However, in such an instance, the entire subset (or product type) of the clearing service would need to be terminated. For example: if the CCP offers a credit clearing service for CDS and CDS index tranches, in the event of a CM's default, the CCP would first proceed through the DMP as stated in the rulebook. This would mean the DMP would encompass all products in the entire, aggregate defaulted CM's portfolio. Typically, the DMP would first seek risk-reducing hedges and then performs an auction that includes all sub-classes of products, in this example, it would be CDS and CDS index tranches. In the event the DMP is not successful, the CCP would be faced with the decision of the complete termination of the credit clearing service. It is possible that the CCP may re-perform the DMP individually by subclass (i.e., CDS and CDS index tranches separately), depending on the outcome of this DMP, it may become evident that the auction may be successful for only subclass of product type while the other subclass of product type may need to be terminated. While this would not impact the netting sets, it may potentially lead to increased costs as it would not allow for offsets between the compartmentalized segments.

We acknowledge that the use of partial termination is preferable over full termination or clearing service termination, however, ISDA does not advocate any formal position regarding the incorporation of partial termination.

- (iv) **Complete Termination:** We strongly support the recovery and continuity of a systemically significant or critical CCP clearing service. As such, recovery of a clearing service is generally preferable to its closure (complete termination), particularly in times of severe market stress. We acknowledge that complete termination may be a recovery tool that may be used to ensure the recovery and continuity of the CCP.
- (v) **Mandatory Replenishment:** We understand the need for the DF to be replenished after it has been used, however, the requirement for mandatory replenishment should not prevent a CM from resigning from the CCP as part of its risk management process to manage its exposures. Further, we support the "cooling off period" after multiple defaults during which ASX may



not call for any mandatory replenishments. The mandatory replenishment should not be used by ASX for any losses that occurred prior to the mandatory replenishment and it should be clearly stated in the respective clearing service rulebook.

ISDA welcomes the opportunity to discuss these matters with you, please contact Cindy Leiw (CLEiw@isda.org) if we may be of further assistance.

Thank you for your consideration.

Yours sincerely,

For the International Swaps and Derivatives Association, Inc.

A handwritten signature in black ink that reads "Keith Noyes".

Keith Noyes
Regional Director, Asia Pacific

A handwritten signature in black ink that reads "Cindy Leiw".

Cindy Leiw
Director of Policy