European Association of CCP Clearing Houses

Response to CPSS-IOSCO Consultative Reports

Assessment methodology for the principles for FMIs and the responsibilities of authorities
and
Disclosure framework for financial market infrastructures

Date: 15 June 2012

Contents

European Association of CCP Clearing Houses

EACH – the European Association of Central Counterparty Clearing Houses – has a long history in promotion of Risk Management Standards: In November 2001 EACH issued the seminal «*Standards of Risk Management Control used by European Central Counterparty Clearing Houses*» with the aim of stimulating associated clearinghouses to provide an objective disclosure of their risk controls and of their fulfilment of the Standards.

The EACH Standards were subsequently recognised and cross-referenced by CPSS-IOSCO, ESCB-CESR, the European Central Bank and by the European Commission. In November 2009 the EACH Standards were superseded by the new EACH Supplementary Risk Recommendations.

In July 2007 EACH established its Risk Management Committee with the purpose to ensure ongoing communication between its members on risk management issues, to discuss and analyse Risk Management techniques and developments, and general risk management issues

General comments

A.1 In this paper we provide our comments per Principle and where applicable per Key Consideration or per Paragraph. However, we first provide some general observations and comments on the assessment methodology and the disclosure framework.

General comments on the assessment methodology

B.1 The assessment methodology framework defines the steps in an assessment, but as far as is possible to understand from the proposed framework, there is nothing mentioned about frequency of the assessment. As for CCPs domiciled in the EU-/EEA-area, where colleges are to be established for the authorisation and supervision of CCPs, there is no reference to this kind of structure - shall the assessment remain with the national supervisors, or shall colleges play a role? Furthermore, the assessment methodology envisages that assessments will be conducted by the CCP itself, by its regulator and by the International Financial Institutions ("IFIs"). However, it is not clear from the methodology which of these assessments would be the definitive one. For instance, what would be the consequence if the CCP's self-assessment differed from the assessment of its regulator, or if the regulator's assessment differed from one conducted by an IFI? Which assessment would take precedence and what is the process for one entity *"appealing"* against the findings of another? Furthermore, the role of the IFIs in ensuring international consistency should be made clear. For example, it would be helpful to clarify that the IFIs should conduct comparisons of the assessments produced by national regulators in order to ensure international consistency both in the application of the assessment methodology and the practical observance of the Principles.

B.2 The rating framework implies setting grades for the assessed CCP with respect to the observance of principles. The CPSS-IOSCO document provides a template for the purpose of performing an evaluation of each principle and each key consideration. This is further supported by a template for prioritised recommendations, for follow up action. However, given the importance of being compliant with the CPSS-IOSCO Principles (e.g. for the purposes of the capital treatment of bank exposures to CCPs under Basel III), it is surprising that the assessment methodology offers no or little information on the process to aggregate ratings or 'scores', nor is there indication of a hurdle or minimum, in order to receive the sought qualification. A central point in our hearing comments should thus be to provide more on the minimum requirements that shall be met and the scoring methodology. It is also not clear how long a CCP would be given to take any necessary remedial action and whether, in the meantime, it would be regarded as observing the Principles or not (and the consequences that this would have for the capital treatment of bank exposures to the CCP under Basel III).

B.3 Moreover, questions that CCPs are supposed to answer under each Key Element are in majority open ended questions, where CCP's and competent authorities will be challenged not only in providing a pertinent answer, but also in interpreting the answer. For example, how shall a CCP answer question 1.2.1: *"How has the FMI demonstrated that its rules, procedures, and contracts are clearly and understandably formulated?"* and even more interesting*, "how shall a*

competent authority interpret an answer, particularly if the methodology is to be applied consistently across CCPs?".

B.4 Questions are in general diffuse, however when the questions enter into a degree of precision, where it becomes possible to apply a quantitative assessment methodology (a simple binary yes/no approach), the level of detail is such that focus is shifted from the real issues relevant for a CCP to matters that in isolation have little or no significance, or requires a significant degree of judgement or interpretation. For example, question 7.3.1 *"What is the estimated size of liquidity shortfall in each currency that would need to be covered to effect settlement of payment obligations, following the default of the participant and its affiliates that would generate the largest aggregate payment obligation in each currency in extreme but plausible market conditions?".* Shall the number be computed on the day the assessment takes place, or is this supposed to be for a period? The relevant question is whether the CCP has a methodology in place so as to monitor the shortfall on a daily basis. Finally, for the purposes of clarity and consistency, references in the assessment methodology to "disclosure" should be replaced by references to *"disclosure as required by the disclosure framework".*

General comments on the disclosure framework

C.1 CCPs accept that they must be accountable to the regulatory authorities who supervise them and, in order to facilitate effective supervision, CCPs must engage in appropriate reporting of relevant information to those authorities on a confidential basis. CCPs also recognise that they must make certain information public, both in order to maintain public confidence in the conduct of their activities and to enable potential users of their services to make informed decisions about if and how to use them. Having said that, a clear distinction needs to be made between confidential disclosure to regulatory authorities to enable them to conduct effective supervision on the one hand and disclosure to the public on the other. EACH recommends that public disclosure should be guided by the principle that it should provide an adequate level of transparency about the general policies and procedures of the CCP, but it must be tempered by a need to avoid undermining the economic utility of CCPs or frustrating the efficacy of their risk management functions. In practice, this means that CCPs should not be required to publish any information which would have a market impact (e.g. information about the positions of clearing members and their customers, and the collateral held against them), details of an operational nature which, if they were made public, would undermine the ability of a CCP to conduct risk management in an effective manner, and the results of testing (e.g. back testing and stress testing) which, if taken out of context or misinterpreted, could inadvertently damage market confidence.

C.2 The disclosure of the principle-by-principle narrative seems to be a very detailed description of every key consideration from the CPSS-IOSCO principles. As there will be a formal review by the respective supervisor (see assessment policy) it would be beneficial if the documentation from this assessment (or parts of it) could be used as a first disclosure document. It should also be possible to combine narratives for different Key Considerations as there is substantial overlap (e.g. between the different KCs in principle 7).

C.3 Most of the guidance given in the disclosure framework is very general so gives room for interpretation as to the level of detail required. It should be made clear that the disclosure should give an overview of the FMIs organization and not describe all details of all the policies and procedures on all areas.

C.4 It should be ensured that the response to the disclosure framework should be made publicly available while respecting the requirement not to publish confidential information in the response.

C.5 Suggested approach: as a principle an FMI should be required to disclose the how (procedures used to obtain qualitative and quantitative sensitive information), while keeping confidential the what (the actual information).

Principle 1: Legal Basis

1.1 We have no comments on this Principle.

Principle 2: Governance

2.1 Key Consideration 1 of this Principle states, that *"An FMI should have objectives that place a high priority on the safety and efficiency of the FMI and explicitly support financial stability and other relevant public interest considerations".*

2.2 The financial stability and public interest are diffuse goals. It might not be possible to put them into a measurable list of targets for a company or individuals.

2.3 Furthermore it remains unclear what "other relevant public interest considerations" should be. More definition would be needed to allow that disclosure frameworks of FMIs are also comparable across competitors.

2.4 Also the objectives of "relevant stakeholders" are not referred to here anymore. In addition a definition of "relevant stakeholder" would be useful.

2.5 Key Consideration 3 of this Principle states, that *"the roles and responsibilities of an FMI's board of directors (or equivalent) should be clearly specified, and there should be documented procedures for its functioning, including procedures to identify, address, and manage member conflicts of interest. The board should review both its overall performance and the performance of its individual board members regularly".*

2.6 It should be clarified that this means the process of the review, not the results of it.

2.7 Key Consideration 5 of this Principle states, that *"The roles and responsibilities of management should be clearly specified. An FMI's management should have the appropriate experience, a mix of skills, and the integrity necessary to discharge their responsibilities for the operation and risk management of the FMI".*

2.8 The definition of "appropriate experience" would be helpful to achieve common standards across FMIs.

Principle 3: Framework for the comprehensive management of risks

3.1 Key Consideration 1 of this Principle states, that *"an FMI should have risk-management policies, procedures, and systems that enable it to identify, measure, monitor, and manage the range of risks that arise in or are borne by the FMI. Risk-management frameworks should be subject to periodic review".*

3.2 It should be clarified, that an overview of policies and procedures is sufficient and not every policy or procedure has to be disclosed.

3.3 Key Consideration 2 of this Principle states, that *“An FMI should provide incentives to participants and, where relevant, their customers to manage and contain the risks they pose to the FMI”.*

3.4 Furthermore Key Consideration3 of this Principle states, that *“An FMI should regularly review the material risks it bears from and poses to other entities (such as other FMIs, settlement banks, liquidity providers, and service providers) as a result of interdependencies and develop appropriate risk-management tools to address these risks”.*

3.5 An FMI has only limited influence on the risk management procedures of its participants. It should be clarified that these Key Considerations relate to the FMI offering tools to participants to manage risk

3.6 Furthermore without knowing the risk position of a third entity it will be impossible for a FMI to assess the risk it poses to others

3.7 Key Consideration 4 of this Principle states, that *“An FMI should identify scenarios that may potentially prevent it from being able to provide its critical operations and services as a going concern and assess the effectiveness of a full range of options for recovery or orderly wind-down. An FMI should prepare appropriate plans for its recovery or orderly wind-down based on the results of that assessment. Where applicable, an FMI should also provide relevant authorities with the information needed for purposes of resolution planning”.*

3.8 Please see our general comment on the disclosure framework C1.

Principle 4: Credit risk

4.1 Key Consideration 5 states that *“A CCP should determine the amount and regularly test the sufficiency of its total financial resources available in the event of a default or multiple defaults in extreme but plausible market conditions through rigorous stress testing. A CCP should have clear procedures to report the results of its stress tests to appropriate decision makers at the CCP and to use these results to evaluate the adequacy of and adjust its total financial resources. Stress tests should be performed daily using standard and predetermined parameters and assumptions. On at least a monthly basis, a CCP should perform a comprehensive and thorough analysis of stress testing scenarios, models, and underlying parameters and assumptions used to ensure they are appropriate for determining the CCP’s required level of default protection in light of current and evolving market conditions. A CCP should perform this analysis of stress testing more frequently when the products cleared or markets served display high volatility, become less liquid, or when the size or concentration of positions held by a CCP’s participant’s increases significantly. A full validation of a CCP’s risk-management model should be performed at least annually”.*

4.2 A CCP should disclose details related to its stress testing program while being allowed to keep confidential the stress testing results. Disclosing such result could potentially destabilise the market, particularly when products cleared or markets served display high volatility or positions are large. As a result, the ability of the CCP to effectively measure, monitor and manage its credit exposure to participants as part of a robust risk framework would be undermined.

Principle 5: Collateral

5.1 Key Consideration 1 of this Principle states, that *"An FMI should generally limit the assets it (routinely) accepts as collateral to those with low credit, liquidity, and market risks".*

5.2 Eligible collateral should be transparent for Clearing Members ("CMs"). Acceptability checks should also be transparent and, ideally, conducted electronically.

5.3 Key Consideration 2 of this Principle states, that *"An FMI should establish prudent valuation practices and develop haircuts that are regularly tested and take into account stressed market conditions".*

5.4 Please see our general comment on the disclosure framework C1.

5.5 Key Consideration 3 of this Principle states, that *"In order to reduce the need for procyclical adjustments, an FMI should establish stable and conservative haircuts that are calibrated to include periods of stressed market conditions, to the extent practicable and prudent".*

5.6 Please see our general comment on the disclosure framework C1.

5.7 Key Consideration 5 of this Principle states, that *"An FMI that accepts cross-border collateral should mitigate the risks associated with its use and ensure that the collateral can be used in a timely manner".*

5.8 Key Consideration 6 of this Principle states, that *"An FMI should use a collateral management system that is well- designed and operationally flexible".*

5.9 Please see our general comment on the disclosure framework C1.

Principle 6: Margin

6.1 Key Consideration 6 of this Principle states, that "A CCP should analyse and monitor its model performance and overall margin coverage by conducting rigorous daily backtesting and at least monthly, and more-frequent where appropriate, sensitivity analysis. A CCP should regularly conduct an assessment of the theoretical and empirical properties of its margin model for all products it clears. In conducting sensitivity analysis of the model's coverage, a CCP should take into account a wide range of parameters and assumptions that reflect possible

market conditions, including the most-volatile periods that have been experienced by the markets it serves and extreme changes in the correlations between prices".

6.2 Please see our general comment on the disclosure framework C1.

Principle 7: Liquidity Risk

7.1 Key Consideration 4 of this Principle states, that *"A CCP should maintain sufficient liquid resources in all relevant currencies to settle securities-related payments, make required variation margin payments, and meet other payment obligations on time with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate payment obligation to the CCP in extreme but plausible market conditions. In addition, a CCP that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions should consider maintaining additional liquidity resources sufficient to cover a wider range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would generate the largest aggregate payment obligation to the CCP in extreme but plausible market conditions".*

7.2 A CCP should not be required to disclose the quantification of minimum and additional liquid resources necessary to meet all its payments obligations under a wide range of potential stress scenarios. Potential stress scenarios may not be consistent across CCPs, and this could result in unfair comparison between CCPs.

7.3 Key Consideration 5 of this Principle states, that *"For the purpose of meeting its minimum liquid resource requirement, an FMI's qualifying liquid resources in each currency include cash at the central bank of issue and at creditworthy commercial banks, committed lines of credit, committed foreign exchange swaps, and committed repos, as well as highly marketable collateral held in custody and investments that are readily available and convertible into cash with prearranged and highly reliable funding arrangements, even in extreme but plausible market conditions. If an FMI has access to routine credit at the central bank of issue, the FMI may count such access as part of the minimum requirement to the extent it has collateral that is eligible for pledging to (or for conducting other appropriate forms of transactions with) the relevant central bank. All such resources should be available when needed".*

7.4 While respecting the requirement to limit its access to qualifying/ supplement liquid resources, a CCP should not be required to disclose what holdings a CCP has.

7.5 Key Consideration 7 of this Principle states, that *"An FMI should obtain a high degree of confidence, through rigorous due diligence, that each provider of its minimum required qualifying liquid resources, whether a participant of the FMI or an external party, has sufficient information to understand and to manage its associated liquidity risks, and that it has the capacity to perform as required under its commitment. Where relevant to assessing a liquidity provider's performance reliability with respect to a particular currency, a liquidity provider's potential access to credit from the central bank of issue may be taken into account. An FMI should regularly test its procedures for accessing its liquid resources at a liquidity provider".*

7.6 Please see our general comment on the disclosure framework C1.

7.7 Key Consideration 9 of this Principle states, that *"An FMI should determine the amount and regularly test the sufficiency of its liquid resources through rigorous stress testing. An FMI should have clear procedures to report the results of its stress tests to appropriate decision makers at the FMI and to use these results to evaluate the adequacy of and adjust its liquidity risk-management framework. In conducting stress testing, an FMI should consider a wide range of relevant scenarios. Scenarios should include relevant peak historic price volatilities, shifts in other market factors such as price determinants and yield curves, multiple defaults over various time horizons, simultaneous pressures in funding and asset markets, and a spectrum of forward-looking stress scenarios in a variety of extreme but plausible market conditions. Scenarios should also take into account the design and operation of the FMI, include all entities that might pose material liquidity risks to the FMI (such as settlement banks, nostro agents, custodian banks, liquidity providers, and linked FMIs), and where appropriate, cover a multiday period. In all cases, an FMI should document its supporting rationale for, and should have appropriate governance arrangements relating to, the amount and form of total liquid resources it maintains".*

7.8 Please see our general comment on the disclosure framework C1.

Principle 8: Settlement finality

8.1 We have no comments on this Principle.

Principle 9: Money Settlements

9.1 Key consideration 3 of this Principle states, that *"If an FMI settles in commercial bank money, it should monitor, manage, and limit its credit and liquidity risks arising from the commercial settlement banks. In particular, an FMI should establish and monitor adherence to strict criteria for its settlement banks that take account of, among other things, their regulation and supervision, creditworthiness, capitalisation, access to liquidity, and operational reliability. An FMI should also monitor and manage the concentration of credit and liquidity exposures to its commercial settlement banks".*

9.2 Please see our general comment on the disclosure framework C1.

Principle 10: Physical delivery

10.1 We have no comments on this Principle.

Principle 11: Central securities depositories

11.1 We have no comments on this Principle.

Principle 12: Exchange-of-value settlement systems

12.1 We have no comments on this Principle.

Principle 13: Participant-default rules and procedures

13.1 We have no comments on this Principle.

Principle 14: Segregation and portability

14.1 We have no comments on this Principle.

Principle 15: General business risk

15.1 Key Consideration 3 of this Principle states, that *"an FMI should maintain a viable recovery or orderly wind-down plan and should hold sufficient liquid net assets funded by equity to implement this plan. At a minimum, an FMI should hold liquid net assets funded by equity equal to at least six months of current operating expenses. These assets are in addition to resources held to cover participant defaults or other risks covered under the financial resources principles. However, equity held under international risk-based capital standards can be included where relevant and appropriate to avoid duplicate capital requirements".*

15.2 Furthermore Key 5 of this Principle states, that *"an FMI should maintain a viable plan for raising additional equity should its equity fall close to or below the amount needed. This plan should be approved by the board of directors and updated regularly".*

15.3 Please see our general comment on the disclosure framework C1.

Principle 16: Custody and investment risk

16.1 Key Consideration 1 of this Principle states, that *"An FMI should hold its own and its participants' assets at supervised and regulated entities that have robust accounting practices, safekeeping procedures, and internal controls that fully protect these assets".*

16.2 Please see our general comment on the disclosure framework C1.

16.3 Key Consideration 2 of this Principle states, that *"An FMI should have prompt access to its assets and the assets provided by participants, when required".*

16.4 Please see our general comment on the disclosure framework C1.

16.5 Key Consideration 3 of this Principle states, that *"An FMI should evaluate and understand its exposures to its custodian banks, taking into account the full scope of its relationships with each".*

16.6 Please see our general comment on the disclosure framework C1.

16.7 Key Consideration 4 of this Principle states, that *"An FMI's investment strategy should be consistent with its overall risk- management strategy and fully disclosed to its participants, and investments should be secured by, or be claims on, high-quality obligors. These investments should allow for quick liquidation with little, if any, adverse price effect".*

16.8 Please see our general comment on the disclosure framework C1.

Principle 17: Operational risk

17.1 Key Consideration 5 of this Principle states, that *"An FMI should have comprehensive physical and information security policies that address all potential vulnerabilities and threats".*

17.2 Furthermore Key Consideration 6 of this Principle states, that *"An FMI should have a business continuity plan that addresses events posing a significant risk of disrupting operations, including events that could cause a wide-scale or major disruption. The plan should incorporate the use of a secondary site and should be designed to ensure that critical information technology (IT) systems can resume operations within two hours following disruptive events. The plan should be designed to enable the FMI to complete settlement by the end of the day of the disruption, even in case of extreme circumstances. The FMI should regularly test these arrangements".*

17.3 Please see our general comment on the disclosure framework C1.

Principle 18: Access and participation requirements

18.1 We have no comments on this Principle.

Principle 19: Tiered participation arrangements

19.1 Key Consideration 2 of this Principle states, that *"An FMI should identify material dependencies between direct and indirect participants that might affect the FMI".*

19.2 Furthermore Key Consideration 3 of this Principle states, that *"An FMI should identify indirect participants responsible for a significant proportion of transactions processed by the FMI and indirect participants whose transaction volumes or values are large relative to the capacity of the direct participants through which they access the FMI in order to manage the risks arising from these transactions".*

19.3 Disclosing the identity of clearing members' clients and the dependencies between members and clients would be difficult due to the confidential nature of the relationship between the two.

Principle 20: FMI Links

20.1 We have no comments on this Principle.

Principle 21: Efficiency and effectiveness

21.1 Key Consideration 3 of this Principle states, that *"An FMI should have established mechanisms for the regular review of its efficiency and effectiveness".*

21.2 There is no definition how to measure efficiency and effectiveness. So this leaves too much room for the FMIs and will not achieve comparability across the industry. Furthermore it is very vague how efficiency and effectiveness can be qualified.

Principle 22: Communications procedures and standards

22.1 We have no comments on this Principle.

Principle 23: Disclosure of rules and key procedures

23.1 Key Consideration 1 of this Principle states, that *"An FMI should adopt clear and comprehensive rules and procedures that are fully disclosed to participants. Relevant rules and key procedures should also be publicly disclosed".*

23.2 The definition of "relevant" rules and "key" procedures is missing and thus leaves room for interpretation. No homogeneous result across the industry can be achieved.

23.3 Key Consideration 5 of this Principle states, that *"An FMI should complete regularly and disclose publicly responses to the CPSS-IOSCO Disclosure framework for financial market infrastructures. An FMI also should, at a minimum, disclose basic data on transaction volumes and values".*

23.4 What is the definition of “basic data”? It should be made clear what kind of data has to be disclosed to allow comparison through the FMIs.

Principle 24: Disclosure of market data

24.1 We have no comments on this Principle.

Annex 2: Key metrics for CCPs

The following should be excluded as it contains either confidential information or is not information that is useful to describe the risk of a CCP:

- Value of routine margin collection vs. non routine margin calls
- Initial Margin requirement of sample portfolios (if regulators want to compare the results an ad hoc request is more appropriate as many CCPs do not have an overlap in products. Also the number of examples would need to be high to reflect effects of cross margining between different products).
- Results of simple standardized stress tests: There is no definition of a standardized stress test.
- Uncovered credit losses and how they are allocated -> not clear what is actually meant as from clearing there should not be any uncovered exposures.
- Investment Risk: Without definition of a specific measure the requirement of disclosing interest rate and fx risk is not practical.

About EACH

EACH has 23 members:

CC&G (Cassa di Compensazione e Garanzia S.p.A.)
CCP Austria
CME Clearing Europe
CSD and CH of Serbia
ECC (European Commodity Clearing AG)
EMCF (European Multilateral Clearing Facility)
Eurex Clearing AG
EuroCCP (European Central Counterparty Ltd)
HELEX AS
ICE Clear Europe
IRGiT S.A. (Warsaw Commodity Clearing House)
KDPW_CCP SA
KELER CCP Ltd
LCH.Clearnet Ltd
LCH.Clearnet SA
MEFF
NASDAQOMX
National Clearing Centre (NCC)
NOS ASA
NYSE Liffe
OMIClear
Oslo Clearing ASA
SIX x-clear AG

This document does not bind in any manner either the association or its members.

Responses to this paper should be addressed to:

Marcus Zickwolff

Chairman

marcus.zickwolff@eurexchange.com

+49 (69) 2111 5847