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28 September 2012

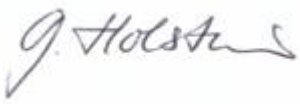
Re: Recovery and resolution of financial market infrastructures consultative report

Dear Sir/Madam,

UBS would like to thank the Committee on Payment and Settlement Systems and the Board of the International Organization of Securities Commissions for the opportunity to comment on the consultative report on 'Recovery and resolution of financial market infrastructures'. Please find attached our response to the paper.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Gabriele Holstein on +41 44 234 4486.

Yours sincerely,
UBS AG



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UBS Response to the Committee on Payment and Settlement Systems and Board of the International Organization of Securities Commissions' Consultative Report on Recovery and Resolution of Financial Market Infrastructures

INTRODUCTION

UBS would like to thank the Committee on Payment and Settlement Systems (CPSS) and the Board of the International Organization of Securities Commissions (IOSCO) for the opportunity to comment on the consultative report on 'Recovery and resolution of financial market infrastructures. Please find below our response to the overall content, as well as the specific questions set out in the Paper. Please note that we have not attempted to answer all questions in the consultation but have focused on the issues of particular relevance to UBS.

Our key comments refer to the possibility for selective tear-up as a loss allocation arrangement prior to the resolution of a CCP. We are not supportive of the possibility of selective tear-up as we do not consider there to be any difference between selective tear-up and forced allocation to a random set of clearing members. It is our view that selective tear-up goes against the concept of loss-mutualisation which is one of the key features of central clearing. Furthermore, as there is no meaningful way to quantify the potential losses arising from forced allocation, such an approach effectively results in an unlimited liability for the non-defaulting clearing members. This will result in significant risk management issues and potential solvency concerns for clearing members. We also believe a proposal where clearing members are exposed to potentially unlimited losses is incompatible with the European Market Infrastructure Regulation (EMIR).

For the reasons stated above, we do not consider that there should be an interim stage of selective tear-up between the auction of a defaulting clearing member's positions and resolution of the CCP. We also emphasise our view that clearing members should not be the only parties required to assume the cost of restoring a CCP to viability. We believe that a CCP's owners and all direct and indirect creditors should potentially be liable for meeting uncovered losses. This approach is necessary to incentivise robust risk management by CCPs and to reflect that a significant proportion of a clearing member's exposures to a CCP result from clearing services provided to clients. We also believe

such an approach will minimise the risk of concentrating losses into a small number of market participants and the potential destabilising impact of such an approach.

3. RECOVERY AND RESOLUTION APPROACHES FOR DIFFERENT TYPES OF FMI

FMIS THAT DO NOT TAKE ON CREDIT RISK

Q: In what circumstances and for what types of FMI can a statutory management, administration or conservatorship offer an appropriate process within which to ensure a continuity of critical services?

We have no comments to provide.

Q: Are there powers beyond those of a standard insolvency practitioner that a statutory manager, administrator or conservator would require in these circumstances?

We have no comments to provide.

FMI THAT TAKE ON CREDIT RISK

Recovery

The consultation states that the CPSS/IOSCO Principles for financial market infrastructures (the Principles) require a CCP, and any other FMI that faces credit risk, to have rules and procedures that address how credit losses in excess of these financial resources would be allocated. That may be through haircuts applied to the margin and collateral owing to surviving participants, and perhaps other participants.

In the case of a CCP, CPSS/IOSCO note that enabling it to recover from a member default requires not only loss allocation but also re-establishing a matched book. Re-establishing a matched book is normally achieved by replacing the defaulter's positions.

If an auction process is not possible, the consultation notes that an alternative solution would be for the CCP's rules to permit for the termination of any unmatched contracts that could not be sold in auction, with cash settlement of them based on a valuation of the gains/losses ("tear-up") to allow for the CCP to remain solvent. For example, the unmatched contracts could be given a final value based on the price at which the most recent variation margin payment obligations from and to participants had been calculated. To the extent that defaulting participants with out-of-the-money positions

had been unable to pay variation margin to the CCP, the CCP's obligations and variation margin payments to all in-the-money participants could be haircut pro rata to the size of their variation margin claims. All other contracts – probably the vast majority of the contracts cleared – could remain in force. But applying this selective tear-up option would alter the balance of surviving participants' portfolio positions vis-à-vis the CCP and, consequently, their exposure to the CCP. This selective tear-up may, however, be considered preferable to the alternative of insolvency and tearing up all contracts cleared by the CCP.

Q: Is tear-up an appropriate loss allocation arrangement prior to resolution of a CCP? If so, in what circumstances?

Please note that, with regard to the questions relating to FMIs that take on credit risk, our responses relate to Central Counterparties (CCPs) only.

We do not support the proposal for selective tear-up as a means of loss allocation prior to resolution of a CCP. The justification for this view is set out below.

Key desirable characteristics of a resolution regime

As an overarching comment, we believe an appropriate resolution regime should seek to i) minimise the risk of CCP insolvency and the associated market disruption and destruction of value and ii) ensure that non-defaulting clearing members are not placed in an economically worse position than they would have been had the CCP become insolvent.

Stages of CCP loss allocation

As a further general point, we believe it is important to distinguish very clearly between three stages of potential actions following the default of one or more of a CCP's clearing members: i) the stage where the default waterfall is utilised to cover losses ii) the potential need for additional 'end of waterfall' measures to address losses resulting from low probability, high impact tail events that create losses in excess of the default waterfall and iii) the potential need for recovery and resolution co-ordinated by the relevant authorities in the case where stages i) and ii) have proved inadequate to restore the CCP to viability.

With regard to stage i) set out above, it is important to note that a CCP will have a default waterfall that determines loss allocation following the default of a clearing

member. The proposals in this consultation should be strictly limited to end of waterfall scenarios where all of the resources in the waterfall have been exhausted and proved insufficient to cover all losses. The proposals in this paper should not interfere with the established default waterfall process as this will create uncertainty and potentially undermine the expected creditor hierarchy and the effective risk management of participants in the waterfall whose exposure may end up being different to that anticipated. The potential for the waterfall to be undermined may also disincentive parties from becoming clearing members in the first place which risks reducing the number of clearing members globally and increasing the concentration of risk which will increase systemic risk.

We believe the proposals in this consultation should only be relevant in extreme tail events and to ensure this is the case, it is necessary that CCPs have considerable resources as a back-stop to manage defaults of clearing members. This requires that the CCP's default waterfall is appropriately calibrated to cover potential losses from the default of significant clearing members in extreme but plausible market conditions. This can be achieved via appropriately calibrated initial margin and default fund contributions from clearing members as well as CCP own capital 'skin in the game' contributions that are appropriately calibrated to ensure i) adequate margins are maintained that reflect the close-out risk and ii) the CCP proactively monitors the creditworthiness of its clearing members and adjusts the required margin for weaker or lower rated clearing members.

We do not believe that the continuity of service provision by a CCP must be ensured under all circumstances as part of an orderly CCP resolution regime. We consider that decisions regarding the merits of re-capitalising a CCP after a resolution event must be left to the private stakeholders of the CCP and it should not be mandated that private stakeholders must continue to support a CCP that has demonstrated weaknesses in risk management. In a rational market economy, it must be possible for non-economically viable CCPs to exit the market. Also, depending on the nature of the CCP (e.g. the volume of derivative contracts cleared or its market share in clearing a certain product), it may not be necessary to prioritise continuity of service provision if cessation of service provision would not have systemic implications.

Distribution of 'beyond the waterfall' losses across different parties

We believe that the CCP's owners and all direct and indirect creditors should potentially be liable for meeting uncovered losses.

This is because, firstly, CCPs are profit making entities and should have the correct incentives to run their business and manage their risks in a prudent manner. For example, we would be very concerned if a CCP could reduce the prudence of its margin requirements or due diligence undertaken on clearing members for commercial reasons in order to win additional business but then not share appropriately in any losses resulting from such lower standards. In other words, the clearing members should not be a backstop for all potential losses of a CCP as it will result in significant moral hazard.

We therefore suggest that, as well as having capital at risk ahead of the default fund contributions of the non-defaulting clearing members, the CCP (i.e. its owners) should be the first to have capital at risk once the total default fund contributions have been wiped out. As discussed previously, this should create the correct incentives for the CCP to calibrate margins and clearing members' default fund contributions appropriately to reduce the risk of its default waterfall 'skin in the game' being required to absorb losses and also to ensure that the aggregate default fund is appropriately calibrated so its 'end of the waterfall' capital is not eroded.

Secondly, a significant proportion of the positions and exposures a clearing member has with a CCP will likely be entered into on behalf of clients of the clearing member who access central clearing through the clearing member. It should therefore be the case that clients of the clearing member are required to assume some of the losses of the CCP provided this is agreed in the contractual relationship between the clearing member and the client.

Thirdly, the general creditors of the CCP should stand to take some losses.

We note that unlike clearing members' clients and other creditors of a CCP, non-defaulting clearing members will have already assumed a significant amount of CCP losses via their pre-funded default fund contributions being wiped out (such losses would be borne by the clearing member alone and not passed onto clients) which is a further justification for a wider allocation of uncovered losses.

The points raised above relate to the mandatory allocation of losses as determined by the resolution authority. We would support flexibility for clearing members to fully meet the costs of restoring a CCP to viability provided this was at the relevant clearing member's own volition.

The need for an equitable distribution of end of waterfall losses

The proposal raises very important questions about what can be considered an appropriate and equitable distribution of end of waterfall losses. The selective tear-up proposal would result in the forced allocation of losses to clearing participants with in-the-money positions.

This approach involves an implicit judgement that parties with in-the-money positions are best placed to absorb losses. We do not believe this will always be the case. For example, given that many clearing members are likely to be members of more than one CCP, it is possible that a non-defaulting clearing member with in-the-money positions relative to the defaulting clearing member's out-of-the money positions at one CCP may itself have out-of-the money positions at another CCP where the relevant clearing member has also defaulted. So, in aggregate, when considering surviving clearing members' positions across all CCPs, it may not always be possible to identify non-defaulting clearing members who are sufficiently profitable to absorb the losses.

Perhaps the most obvious alternative means of allocating losses via selective tear-up would be to allocate losses on a pro-rata basis relative to, for example, the size of the non-defaulting clearing member's default fund or initial margin contribution to the CCP. But, this would also not necessarily allocate losses to parties most able to bear them, as such clearing members are likely to have already suffered material losses via the exhaustion of their pre-funded CCP default fund contributions.

In light of this, we again note that it is crucial that any loss allocation is not just restricted to clearing members, but that losses can be allocated to clients of clearing members based on the contractual arrangements in place.

Concerns with selective tear-up

We do not support selective tear-up as a means of allocating losses ahead of resolution. This is because, in our view, there is no difference between selective tear-up and forced allocation to a random set of clearing members. As with forced allocation, using a theoretical final value for positions immediately preceding default is ambiguous and

inappropriate - the only realistic price is the one determined during an auction bidding process. There is no justification for a CCP to unilaterally specify that their theoretical value is "more correct" than that determined by market participants. This is especially true if a previous auction had only partially cleared the defaulter's portfolio as this indicates that the residual portfolio is toxic, either in market risk or liquidity.

Selective tear-up also goes against the whole concept of loss-mutualisation which is one of the key features of central clearing. There is no meaningful way to quantify the potential losses arising from forced allocation as a result of selective tear-up making this equivalent to unlimited liability for the non-defaulting clearing members.

Furthermore, the non-defaulting clearing members under selective tear-up are distinctly worse off than when facing a counterparty bilaterally. In a bilateral relationship, a counterparty has the ability to control exposures and stop trading if the risks are deemed too high. With central clearing, the bilateral exposure is supposed to be removed. However, if selective tear-up is allowed, this introduces "re-bilateralisation" risk which clearing members have no control of. Contrary to footnote 10 of paragraph 3.14 of the consultation, the "re-bilateralisation" risk is not distinct from selective tear-up since the loss mutualisation is only in respect of the theoretical mark-to-markets whereas the real exposure is against the market-determined price (which for the purposes of the selective tear-up proposal, is so far away that it blows through the entire default fund).

Therefore, we strongly believe that the appropriate mechanism for allocating end of waterfall losses is as follows:

Stage 1: Positions of the defaulting clearing member should be subject to an auction process. If surviving clearing members are willing to take on the defaulting clearing-member's portfolio at the auction, the losses will be allocated across the relevant surviving clearing members and the CCP may be able to continue to operate.

Stage 2: If the auction process is unable to allocate all losses because there are no surviving clearing members willing to buy the defaulting clearing member's portfolio, or if the price demanded by the surviving clearing members would be too high for the positions to clear, the CCP should be resolved and losses allocated via full tear-up of contracts. In such a case, the relevant resolution authority would collect cash from non-defaulting clearing members with out-of-the-money positions (i.e. those owing cash to

the CCP) and would pay cash to non-defaulting clearing members with in-the-money positions (i.e. those owed cash from the CCP). To the extent there was a shortfall in the amount of cash owed to clearing members, each clearing member would receive a pro-rata allocation of the available funds. We note that full tear-up then effectively results in some degree of variation margin haircutting as the clearing members owed variation margin may not receive the whole amount due to them as a result of the pro-rata allocation process.

We do not consider that there should be an interim stage of selective tear-up between the auction and resolution for the reasons set out above, namely, that such an approach would result in the non-defaulting clearing members having an unlimited liability and undermine loss-mutualisation which is a key construct of central clearing.

Legal constraints on the potential for variation margin haircutting

In addition to the concerns raised above, we believe the proposed variation margin haircutting approach may be difficult to implement in the EU given constraints imposed by EMIR. Specifically, EMIR Article 43, 3. states that "a CCP may require non-defaulting clearing members to provide additional funds in the event of a default of another clearing member" but Article 45, 4. states that "a CCP may not use the margins posted by non-defaulting clearing members to cover the losses resulting from the default of another clearing member". So the CPSS/IOSCO margin haircutting proposal appears to be prohibited by EMIR. As global consistency of approach is crucial in a market as global as derivatives, we would encourage CPSS/ISOCO to engage with relevant EU policymakers, including the European Commission, to ensure any international framework is capable of full implementation across the world's largest derivatives markets.

Q: Should there be a limit to the number of contracts that are eligible for tear-up? How should the appropriate haircuts be determined?

The economic rationale for limited liability for clearing members

As set out in our response to the previous question, we do not support unlimited liability for clearing members. The potentially un-quantifiable contingent liability this would create for clearing members and the potential impact on their solvency would create significant contagion risk given the likelihood of a clearing member at one CCP being a clearing member at other CCPs. It would also act as a huge disincentive for clearing members to offer clearing services to their clients and may significantly increase the

number of firms who are unable to find a viable clearing solution with the consequence that many firms who currently use derivatives for risk management purposes may become disenfranchised and unable to hedge those risks. This will increase the level of systemic risk in the system. It is also very unclear how prudential regulators would view clearing member's unlimited contingent liability to a CCP but we believe it would raise significant risk management and capital adequacy concerns.

Furthermore, selective tear-up also has the potential to concentrate significant losses in a small number of clearing members/clients. As such, the process could significantly destabilise the clearing members most impacted, with potential systemic implications, particularly if such parties are also clearing members at other CCPs.

Variation margin haircutting is not a risk that can be prudently managed by clearing members or clients. As such, we consider the risks arising from variation margin haircutting to be different to the scenario in which a clearing member's or client's contracts are to be torn-up, as in the latter situation, the party knows their risk and can immediately go into the market and re-hedge.

Legal constraints imposed by EMIR

From a legal perspective, we believe it would be necessary to cap the liabilities of clearing members in order for the proposals to be compatible with EMIR. This is because EMIR Article 43, 3. states that 'a CCP may require non-defaulting clearing members to provide additional funds in the event of a default of another clearing member. The clearing members of a CCP shall have limited exposures toward the CCP'. Thus unlimited clearing member liability appears to be inconsistent with EMIR, which, as an EU Regulation, cannot be overridden by national law.

Q: To what extent should the possibility of a tear-up in recovery be articulated in ex ante rules?

We believe that certainty for market participants is crucial. We would therefore support clear ex-ante articulation of the recovery process. Such articulation should make clear the different circumstances under which different actions would be triggered and be clear as to the potential liabilities for each participant arising at each stage. As explained above, we do not believe selective tear-up should form part of the recovery process.

RESOLUTION

The consultation states that while an FMI's loss allocation rules may act to reduce significantly the risk of resolution becoming necessary, they cannot be guaranteed to be sufficient in all circumstances. If so, and where the triggers for taking the FMI into resolution are satisfied, the resolution authority should have available to it a broad range of resolution tools. Among these, loss allocation supported by statutory powers is likely to be an essential tool if critical services are to be continued. It is proposed that further loss allocation could be implemented through haircutting of margin and by enforcing any outstanding obligations under the FMI's rules to replenish default funds or respond to cash calls.

CPSS/IOSCO note that, while clients may not have a direct contractual relationship with the CCP, their contracts with participants may include provisions for any losses suffered on the participant's contract with the CCP to be passed on to the client. Thus, margin-haircutting solutions are likely to involve losses falling on these clients as well as on the participants.

The consultation states that another question for consideration is the point at which equity owners of the FMI should suffer losses. It is highlighted that imposing losses on equity holders may lead to complications for resolution in some circumstances – for example, where the owner of the FMI operates not only the service in which a participant default has occurred and for which resolution is necessary, but also operates other critical FMI services. In these cases, wiping out the FMI's equity might necessitate the resolution of other critical market services that it runs.

Q: What qualitative or quantitative indicators of non-viability should be used in determining the trigger for resolution for different types of FMI?

As a general principle, we believe that the triggers of intervention in recovery and resolution should be as predicable as possible because of the need of market participants, and particularly creditors, for clarity. We would expect that the key indicator for resolution of an FMI would be the FMI's own assessment that it will be unable to meet its obligations.

Q: What loss allocation methods must be available to a resolution authority, and for which types of FMI? Could or should these resolution powers include tear-up, cash calls or a mandatory replenishment of default fund contributions

by an FMI's direct participants? Does it make a difference if the losses are from a defaulting member or are made up of other losses (eg losses in investments made by the FMI)? In what circumstances, and by what methods, should losses be passed on beyond the direct participants – eg to the clients or FMI shareholders – in resolution?

Range of loss allocation methods

Please see our previous comments on the use of selective tear-up and variation margin haircutting.

The need for a different approach depending on the circumstances in which losses are incurred

We believe a distinction should be made between circumstances in which a CCP cannot meet its threshold conditions as a result of i) losses directly incurred from its clearing activities and ii) losses incurred via other means (such as losses on its investments). Under scenario i), we consider it appropriate that losses are shared between the CCP owners, clearing members, clients of clearing members and general creditors of the CCP. But under scenario ii), we do not consider it appropriate that clearing members or their clients should be required to contribute funds to restore a clearing house to viability. This is because there is a significant moral hazard if clearing members were, for example, expected to meet a CCP's uncovered losses incurred as a result of the CCP undertaking a highly risky approach to investing margins in order to maximise profits for the CCP's owners. In such a case, the CCP would have a highly asymmetric risk profile in that its owners would benefits from additional profits if the investment strategy was successful but would not incur a significant proportion of the losses if it were unsuccessful. We therefore do not believe that clearing members should be mandated to share in a CCP's uncovered losses resulting from non-clearing activities (although they should have the discretion to do so should they wish).

Q: What, if any, special considerations or methods should be applied when allocating losses whose maximum value cannot be capped (eg when allocating potential losses that might arise from open and uncapped positions at a CCP)?

Please see our previous comments on unlimited liability.

Q: How should equity in FMIs be treated in resolution scenarios: should it be written down in all circumstances?

We have no comments to provide.

Q: Are there circumstances in which loss allocation in resolution should result in a different distribution of losses to losses borne in insolvency? Does it make a difference if the losses stem from a defaulting member or are made up of other losses (eg losses in investments made by the FMI or resulting from operational risks)?

We have no comments to provide.

Q: Should an FMI's rules for addressing uncovered losses be taken into account when calculating whether creditors are no worse off in resolution than in liquidation?

We have no comments to provide.

Q: Are there any circumstances in which the ability to exercise termination rights as a result of the use of resolution powers should outweigh the objective of ensuring continuity? Are there any circumstances in which a temporary stay on exercising termination rights should apply for any event of default and not just where triggered by the resolution measures?

The CPSS-IOSCO paper suggests in this paragraph that if certain CCP participants exercise early termination rights, the CCP may no longer have a "matched book" and therefore run market risk. On this basis, CPSS-IOSCO recommends the power to impose a stay on exercising termination rights.

Clarification sought on meaning of 'termination rights'

We are not clear as to exactly what is meant by 'termination rights' and would appreciate clarification of this term.

No restrictions should be placed on the ability of a clearing member to terminate their clearing membership of a CCP

For the purpose of this response, our interpretation is that termination rights refer to the rights of a clearing member to terminate their clearing membership with a CCP.

We do not follow the argument that termination creates an un-matched book for the CCP as a clearing member cannot complete their membership termination without first having de-cleared all their transactions (closed the positions or transferred to an alternative clearer). As far as we are aware, there are no provisions within any CCP which allows it to have an un-matched book, unless specifically arising from a defaulted member's portfolio.

On this basis, we do not agree with resolution powers allowing for a temporary stay on exercising termination rights. This is a fundamental right for clearing members to manage their business risks and any resolution powers that prevent a clearing member from resigning discriminate against clearing members and subordinate the survival of a clearing member relative to a CCP.

4. IMPORTANT INTERPRETATIONS OF KEY ATTRIBUTES WHEN APPLIED TO FMI

The consultation notes that a separate resolution tool required by the FSB under Key Attribute 3.5 is "bail-in within resolution". While bail-in should cover a broad range of liabilities, the bail-in tool is most suited to resolving financial institutions with a capital/liability structure that includes a substantial proportion of debt securities and other creditor claims. Unlike banks or investment firms, most FMIs typically do not have such a capital/liability structure. Some FMIs, such as CCPs, do, however, hold significant amounts of variation and initial margin as well as default funds. Where one or more of these sources have not yet been exhausted under the FMI's own loss allocation rules but the FMI's losses are still not fully covered, it may be preferable to haircut the creditor's claims to them and give these creditors equity in the FMI through the mechanism of bail-in in resolution rather than resort to liquidation. As with other resolution tools, the haircut would respect the creditor hierarchy and would apply to collateral and margin only where it was held in a way that meant that it would bear losses if the FMI became insolvent.

Q: Are there any circumstances in which a moratorium with a suspension of payments to unsecured creditors may be appropriate when resolving an FMI? Should this be limited to certain types of FMI and/or certain types of payment?

We have no comments to provide.

Q: If so, should resolution authorities retain the discretion to apply a moratorium and, if so, what restrictions (if any) on its use would be appropriate (eg scope, duration or purpose)?

We have no comments to provide.

Q: Should the bail-in tool be available to collateral, margin (including initial margin) and other sources of funds if they would bear losses in insolvency?

We consider it to be crucial that that the treatment of initial margin is determined by the CCPs rules and, in particular, according to the loss allocation imposed by the default waterfall (including where initial margins are segregated by client and by asset class in cases where each class has a separate default waterfall). Initial margin provided to CCPs is supplied for specific risk mitigation purposes. Also, initial margin has been mandated in accordance with the G20 requirements for central clearing. Such margins should not therefore be treated as general creditors' claims as per a typical commercial insolvency. Any treatment of such funds as general creditors' claims will likely create uncertainty, undermine effective risk management and disincentivise the provision of clearing services.

Q: In what circumstances and for what types of FMI should wider loss recovery arrangements exist beyond the FMI's own rules and the resolution powers of the resolution authority?

We have no comments to provide.

Q: In conducting a resolvability assessment of an FMI, what factors should authorities pay particular attention to?

We have no comments to provide.