

July 29th, 2011

Letter to be submitted by e-mail to cpss@bis.org, and fmi@iosco.org

Reference: CCP12 response to Public Consultation on Principles for Financial Market Infrastructures, July 2011

Mr. Daniel Heller,
Head of Secretariat, CPSS
Mr. Masamichi Kono,
Chairman, IOSCO Technical Committee

Dear Mr. Heller and Mr. Kono,

CCP12 The Global Association of Central Counterparties welcomes the latest initiative taken by the Committee on Payment and Settlement Systems (“CPSS”) and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) by publishing the consultative report on “Principles of Financial Market Infrastructures” (“Principles for FMIs”) in March 2011 and is grateful about the opportunity to comment on this report.

CCP12 recognizes that as institutions of systemic importance, our Central Counterparties as well as the robustness of their risk management measures are crucial to the long term stability and competitiveness of the global financial markets, making the Principles for FMIs particularly relevant to the management of our business activities and for the markets we serve.

The Principles are useful as an important set of international standards on payment, clearing and settlement systems for all FMIs covered but in particular for those which are systemically important. CCP12 agrees that it is an opportune time for reviewing and strengthening international regulatory standards and is particularly supportive of CPSS-IOSCO’s focused attention on bolstering systemic risk protection globally. That said, it is important to recognize the diversity of economic, legislative and regulatory environments which CCPs operate around the globe in order to resist being over-prescriptive with “one-size-fits-all” approaches for all aspects of how CCPs are expected to operate in order to avoid unintended consequences.

To enhance the effectiveness of the standards as well as to transparent the associated impact ahead of putting them into effect, it is equally important that CPSS-IOSCO give careful consideration to the feedback from industry organizations such as CCP12; FMIs and their respective stakeholders.

CCP12 response is integrated by the three following categories that are attached in an Appendix

- The **General Positioning**, that offers a high level view of the Association on key aspects of the report,
- A set of **25 Recommendations** on which there is a general CCP industry consensus, and
- **7 key issues on which CCP12 members' views vary**, where no complete consensus on some important topics has been reached.

We look forward to our comments and recommendations being taken into consideration ahead of the Principles being implemented and to ongoing contact and cooperation with CPSS-IOSCO to aid in the successful outcome in this important endeavor.

Sincerely yours,

Luis Jorge Pelayo
Chair CCP12

CCP12 General Positioning

Introduction

CCP12, The Global Association of Central Counterparties, was formed in 2001, and is currently comprised of 27 members that operate major central counterparty (CCP) clearing house organizations across Africa, the Americas, Asia, Australia and Europe. These experienced members handle over 35 separate CCPs across an extensive range of OTC and exchange traded markets, both cash and derivatives, covering equities, fixed interest, commodities and energy. There is therefore substantial diversity across CCP12 membership in approach reflecting at times complex differences in

- market protocols
- local legislation and regulatory expectations
- payment, trading and settlement systems with which the CCP interacts
- product coverage
- nature of the contractual obligations e.g. CCP relationship with the end user/client
- nature of the business e.g. listed/mutualised/vertical/horizontal; and
- type, size and counterparty standing of the CCPs' members / participants

The association and its membership always consider it a privilege to be associated with various CPSS-IOSCO initiatives to set and/or improve standards for the CCP industry. It may be pertinent to highlight here that CCP12 offered its views to CPSS-IOSCO Committee at the time of formulation of October 2004 Recommendations for Central Counterparties which were duly considered by the Committee. It likes to believe that the fruitful association which was started then had laid foundation for creation of a robust and efficient CCP industry which continued to enjoy market confidence even during the worst of recent credit crisis. It gratefully acknowledges and appreciates the consideration that CPSS-IOSCO Working Group has shown to it in by inviting its members for consultations, once in Basel in 2010 at the time of considering revision to October 2004 CPSS-IOSCO Recommendations for Central Counterparties in the context of OTC derivative settlements "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs" and again in London in June 2011 in the context of issues pertaining to the Principles covered in March 2011 Consultative report.

CCP12 observes that the current effort through the report is to raise the standards for CCP industry. Draft proposals advocate raising of standards in most, if not all, areas either through:

- explicit increases to the magnitude of key thresholds on existing standards or
- through the introduction of additional detail on existing standards or
- through entirely new standards

While it appreciates the intent behind such an effort, it would like to bring to the notice of the Committee that there are potential significant cost implications including hefty opportunity cost for meeting such raising in standards. Its membership is worried that the increased cost and compliance requirement sought to be brought in through the changes/modifications should not lead to dissuade the users of CCP services to look for other cost-effective services, even if those means taking risks of a higher order. CCPs across the world demonstrated the systemic strength that they provided throughout the global financial crisis (GFC). CCP12 membership therefore wonders whether the steps being suggested in some cases like liquidity stress test are proportionate to the necessity.

CCP12 members would also like to clarify that although numerous CCP12 members are vertically integrated, these comments pertain to their CCP functions only. As this is a submission which seeks to consolidate the views of all membership and thus tends to lose the focus that some of its members would like to have, its members are encouraged by CCP12 to make separate submission if they so choose. CCP12 therefore would like to clarify that CPSS-IOSCO Working Group may receive such separate submission.

Notes on CCP12 Submission

CCP12 submission provides a list of recommendations on which there is a general CCP industry consensus. In addition, where no complete consensus has been reached (on some important topics) commentary is provided on the alternative points of view and their rationale.

It would also like to add that as no assessment criteria have been published, without which analysis of the impact is less clear, CCP12's comments may need further modulation when the assessment criteria is made public.

Moreover, given the size of the document, we have concentrated on a select number of topics identified by CCP12 members as priority issues.

CCP12 therefore considers it necessary to highlight as under:

- It is essential that the CPSS-IOSCO Working Group assess the impact of the unintended consequences of the raising of individual standards and perhaps most importantly the impact on a holistic basis, especially any negative consequences on the broader policy objectives e.g. encouraging the use of centrally cleared markets
- Clearing Participants' commerciality and any associated implications for market efficiency and greater risk concentration for the CCPs
- Specific types of important business activities that may be obstructed e.g. capital and liquidity intensive activities such as arbitrage trading

- The ability of CCPs to attain the revised standards within the time-frame which has been referenced in the cover letter accompanying the draft Principles, especially as implementation is not just by the CCP (or FMI) acting on its own, but also would require significant market buy-in or participation by the CCP/FMI's participants in the manner of market practice changes or system changes
- The ability of CCPs to attain the revised standards without making what may be perceived by market participants as excessive capital demands or liquidity constraints of those same market participants.

CCP12 Recommendations

GENERAL

1. CCP12 is keen to establish the assessment criteria and recommends that the Principles and Key Considerations should be regarded as minimum international standards should be clearly specified in the document. Other principles where national Regulators can exercise some judgement should also be clearly stipulated. The Explanatory Notes should provide background and guidance to best practice, but should not form part of the standards to which CCPs must adhere to demonstrate compliance.

In developing an industry response to the consultation document, CCP12 members have often found it difficult to comment in the absence of an assessment criteria. This has prompted much debate as to whether the objective is to establish industry best practice or minimum international standards. Indeed, bilateral discussions with CPSS-IOSCO committee members and local regulators have yielded conflicting views.

CCP12 members recognise that the wide diversity of appropriate CCP models makes it very difficult to create a generic approach and that a holistic view of a CCP's risk management protections is often very useful. Therefore there will always remain a need for national discretion to reflect local market characteristics and jurisdictional issues. Accordingly, CCP12 believes that the best means of balancing the need to establish consistent standards with provision of the appropriate scope for holistic assessment by regulators would be to establish certain Principles and Key Considerations to be stipulated as minimum standards with the accompanying Explanatory Notes providing guidance to regulators on best practice.

2. CCP12 believes it is very important to ensure feedback has been received from market users, especially Clearing Participants, before finalising the Principles and suggest that CPSS-IOSCO consider an additional round of market consultation, perhaps when the assessment criteria are made available and first round comments have been considered, and where appropriate, included.

Many CCP12 members expressed a concern that their Clearing Participants and other market users would not be in a position to provide comprehensive feedback on the consultation. This was viewed as an important step as the cost of compliance with the raised standards is likely to be borne by these institutions. The principles are lengthy and complex, reflecting the substantial amount of work undertaken by the international regulatory authorities, but as a result, FMIs have needed several months to assess the cumulative impact of

the proposal and have only relatively recently been able to share their findings with their stakeholders. Many of the market users have understandably been focussed on the plethora of more direct regulatory changes impacting the financial sector and have therefore been able to spend little time considering the impact of these Principles.

3. In order to assist CCP12 members explain the basis for the proposed changes and the resulting impacts to their market users, CPSS-IOSCO should provide a detailed rationale for each higher or additional standard.

In discussions between CCPs, and with Clearing Participants, it has at times been unclear why a particular standard has been proposed. In the absence of specific commentary explaining some important proposed changes, it has been difficult explaining the reason for the likely impact on market users. To assist with CCPs future engagement with market users in implementing the changes, CCP12 members would welcome further clarity on the rationale for key changes in CCP standards (e.g. disallowing Contingent Resources as CCP financial resources).

4. Subject to the miscellaneous comments in Appendix B, CCP12 members are broadly in agreement with the following Principles:

- **10) Physical deliveries**
- **16) Custody and investment risk**
- **20) FMI links**
- **21) Efficiency and effectiveness**
- **22) Communication procedures and standards**
- **23) Disclosure of rules and procedures**

5. CCP12 proposes that all references to the need for mandatory independent validation of CCP processes be removed from the Standards.

In various sections of the document, the proposals seek to utilise independent validation of CCP processes, risk models and approaches. CCP12 members believe that the need for external validation of any specific item is not uniform and should be at the discretion of the CCP or when agreed between the CCP and its domestic regulator. Usually, given the inherent expertise within the organisations, the CCP and the regulators will provide sufficient oversight without the need to revert to external guidance. In some cases where an independent view is seen as beneficial, an internal review by another department of the CCP, e.g. internal audit, would be equally appropriate.

LEGAL

6. CCP12 members strongly oppose the need to routinely obtain independent legal advice to support each aspect of its activities. Use of independent legal advice should be reserved for key contentious issues as determined by CCPs in consultation with their national regulator.

Section 3.1.4 advocates the use of independent legal advice to support all of a CCP's activities. CCP12 members believe that the use of independent legal advice should be targeted at specific issues where either the CCPs or national regulators have identified a legal risk on which additional independent input is beneficial. On most issues, CCPs and regulators will already have the legal expertise to form opinions on the legal robustness of a CCP's activities. In such circumstances, external advice would add little to the understanding but generate unnecessary costs for the CCP.

GOVERNANCE

7. CCP12 members believe that, given their crucial role in preserving the stability of the financial system, CCPs should be provided with access to appropriate central bank settlement systems.

CCP12 members believe that CCPs should be given the right to directly access central bank payment systems to facilitate margin and delivery payments. Although the use of commercial banks as intermediaries is not viewed by CCP12 as a reason for non-compliance with the Principles, CCPs believe that the additional certainty provided by central bank facilities including provision for any intra-day credit is industry best practice and should be afforded to CCPs to reflect their crucial role in managing systemic risk.

8. CCP12 recognises the importance of good, transparent governance arrangements, especially for CCP risk management activities. Accordingly, CCP12 sees no reason as to why the membership of CCP Risk Committees should be limited to the organisation's Board members. CCP12 members, however, are fully supportive of Risk Management Governance principles listed in paras 3.2.11 and 3.2.12.

CCP12 members successfully use a variety of risk management governance models, in some cases determined by the broader corporate governance requirements of their particular jurisdictions. Whilst not suggesting that drawing Risk Committee members solely from the Board is not an appropriate governance structure, CCP12 is unsure of the benefit of restricting committee members in this way. Indeed several CCP12 members consider that the use of external experts and/or customers in this role is highly beneficial.

Some of the CCPs however believe that two tier Risk Management Committee structure, one at Board level and another at operations level with external experts/customers also as member could be an appropriate solution.

9. Whilst recognising that the needs of a CCP are generally aligned with the needs of the ‘public interest’, given the diversity of CCP governance models, it is important to note that it may not be possible for all CCPs to always act in the public interest.

While in many cases it is probable that CCP actions will typically be consistent with the ‘public interest’, not least as not doing so raises reputational risks, it is conceivable that in certain circumstances the interests of CCPs and the public interest may necessarily diverge: For example, in a default, some end-users may end up being disadvantaged by particular actions taken by CCP to preserve systemic stability. Indeed in many CCP12 member jurisdictions, company directors have specific duties which are enshrined in law that may in some circumstances run contrary to upholding the public interest. In one jurisdiction, however, domestic legislature deems that it is necessary for such a requirement.

In addition, CCP12 members have noted that the public interest is a difficult concept to define and in practice does not represent a single view as CCPs are frequently faced with decisions that benefit one set of market users to the detriment of another group.

10. Although CCP’s should and do support, where practical, the risk management activities of their Participants, it is not the role of a CCP to perform those tasks on behalf of the Participant.

CCP12 members recognise the benefits of well risk managed Clearing Participants and understand that it is in the interests of CCPs and the markets which they serve to support Clearing Participant risk management activities where possible. CCPs, however, need to primarily focus on their own risk mitigation practices. It is important to note that where CP exposures span multiple exchanges or are combined with OTC exposures, the objective may not in any case be attainable by the CCP alone.

CREDIT

11. CCP12 members believe that the principles should explicitly state that the results arising from stress testing using the most extreme theoretical scenarios, not observed in the appropriate historical data, should be used for informational purposes only.

CCP12 members consider that extreme theoretical scenarios, which are not observed in historic data, may provide valuable information to assist risk understanding and may help fine tune other risk quantification models. In some circumstances, usually where price histories are limited, CCPs may choose to include these scenarios as part of the range used to determine a CCP’s capital requirements. However, it is important that there is no expectation that CCPs are required to maintain risk resources against such possible losses.

It would also be beneficial for the document to acknowledge that reverse stress tests may produce misleading results where the CCP clears multiple products/asset classes especially where the initial margin requirements permit offsets between products. Reverse stress tests should therefore be used only where results are beneficial to understanding a CCP's risks.

12. Avoiding wrong-way risk through prohibition is not in many cases practical or possible, but such risk should instead be carefully monitored and where required limited.

Whilst CCP12 members recognise the dangers of permitting their counterparties entering into derivatives transactions directly-related to the counterparty standing of the Clearing Participant, CCPs face a number of practical obstacles to their ability to limit wrong way risk. For example, where a CCP has exposures to a Clearing Participant in equity/bonds cash and/or options markets, perhaps arising from client activity, it is not practical to prohibit such exposures (e.g. Citibank clearing client trades in Citibank stocks). Some CCP12 members have suggested that the prohibition of client lodgement of related collateral may also not be the optimum solution given the separation between the client and house accounts.

CCPs should instead be expected to have adequate risk quantification and monitoring in place to assess such risks and mitigate them appropriately either in the form of additional margin cover or the enforcement of limits.

13. Close out periods for margining should be based on normal market liquidity conditions, not those that may occur in a stressed market environment. This also ensures consistency with the proposed confidence intervals.

Principle 6 recommends that a CCP should base its margining assumptions on the close periods expected in a stressed market conditions. CCP12 members believes that this runs contrary to the objectives of margining which is to estimate potential close out losses in 'normal market conditions' as defined by the minimum confidence interval of 99% articulated in the Principles. CCPs maintain other forms of risk management protections such as the CCP's own financial resources. CCP12 advocates the retention of the wording in the current CPSS-IOSCO standards (3.4.9).

14. CCP12 members seek to prevent negative procyclical impacts where possible, but the Principles should explicitly recognise that CCPs primary systemic risk protection is to maintain its own robustness and therefore set margin rates/collateral haircuts at a level that is appropriate for current market volatility.

While CCPs are mindful of the impact to the wider market from their risk management activities, the best way for CCPs to promote systemic stability is to undertake actions which ensure their own solvency. Ostensibly, the

proposed requirement is incompatible with setting margins at 99% confidence intervals and the use of stressed price movements in excess of margin assumptions, as set out elsewhere in the document. Other members consider that the proposal is inefficient as the use of stressed price assumptions as margin rates or collateral haircuts is the only way to prevent margin increases at times of increased short term volatility. Some have also expressed concern that implementation of such an approach may see collateral demand increases of such levels that the availability of high quality collateral in some markets may become squeezed.

15. When determining the level of stress testing severity, CCP12 members believe that CCPs need only consider observed stress moves that occurred during periods where the prevailing market structure at the time is similar to the current market structure in which the CCP is now operating.

Given the rapid development of financial markets around the world it is important that CCP stress testing scenarios reflect the price behaviour of the markets currently cleared by the CCP. In particular CCP12 members believe that CCPs must avoid using excessive price moves on the basis that such moves have been seen historically but in markets that bear little relation to the more complex markets of today. CCP12 members consider that in some instances it may not be appropriate to require CCPs to take into account historical peak volatility where the observed move took place long ago and in a market significantly different to those today. For example, price behaviour, especially in stressed market conditions, of a floor traded market of 30 years ago is not representative of that likely to be experienced today. Some CCPs have pointed to stressed price behaviour during the Global Financial Crisis as further evidence to support such a view – unlike the significant 1-day volatility associated with the 1987 crash, daily price volatility was much more subdued notwithstanding the extreme events unfolding.

16. CCP12 would welcome the opportunity to collaborate with CPSS-IOSCO and other international regulatory organisations to identify key stress testing standards on which there is a basis to standardise CCP stress testing principles.

CCP12 acknowledges the correspondence from CPSS-IOSCO exploring the possibility of determining a common set of stress testing /capital adequacy standards for the global CCP industry. Due to CCP12's focus on this submission, it was not possible to undertake the work requested. However, CCP12 is committed to engaging with international regulators to further discuss the feasibility of such an approach.

COLLATERAL

17. Acceptance of contingent assets as eligible collateral at a CCP, such as bank guarantees/letters of credit, should continue to be permitted within appropriate limits and supported by robust monitoring procedures, as determined by the respective CCPs and their local regulators.

Contingent assets such as bank guarantees and letters of credit have proven to be reliable forms of collateral, especially during periods of market instability such as during the recent Global Financial Crisis. CCP12 members consider that CCPs should continue to be able to accept a wide array of collateral, including contingent assets, to ensure diversity of risk. The importance of the diversity of collateral should not be underestimated nor where there are direct links between the exposure arising from open positions and the collateral held.

CCP12 members, however, accept that it is important for the risk associated with each collateral type to be monitored and where appropriate subject to limits. In certain cases, such as the issuer being related to the Clearing Participant, prohibition is appropriate but CCPs should be able to determine their own policy in relation to contingent assets as eligible collateral in consultation with their home regulator.

At least one CCP however feels that Bank Guarantees/Letters of Credit, not being tangible assets or actionable claim unless some further event has happened, these cannot be treated as collaterals.

SETTLEMENT FINALITY

18. Delivery failures to CCPs are an inevitable characteristic of settlement systems and should be explicitly recognised in the Principles. In addition, during default events, CCPs must be able to provide for Rule and Procedures to reschedule payments/settlements as an important risk management measure to alleviate liquidity pressures and ensure the viability of the CCP, particularly in situations where heightened systemic risk is evident.

Several CCP12 members have raised this issue, when combined with the liquidity stress testing requirements as having the most wide-ranging impact of all of the changes proposed in the document. Currently the standards are not totally clear with the definition of the term 'trade date' being critical to the meaning and purpose of this section. Informal discussions with national regulators have also shown a variance in interpretation of the proposed standards.

The most conservative interpretation of the text suggests that both delivery fails and rescheduled settlements are prohibited in all circumstances. As a result, CCPs/CSDs would need to 'buy in' ahead or on the morning of the

scheduled settlement date to ensure that all deliveries are made and, even in the default of the most active market participant, CCPs would be unable to reschedule/defer settlements to manage liquidity stresses.

CCP12 strongly believes that, whilst FMIs should do all possible to limit their number, delivery fails are a characteristic of all market settlement systems and need to be acknowledged in the CPSS-IOSCO document. Indeed in many cases achieving such an onerous target is not possible given the likely illiquidity of the those stocks expected to fail – some CCP12 members currently attempt to undertake pre-scheduled buy ins and are unable to achieve 0% delivery fails.

Furthermore, the ability to reschedule settlements of a defaulting participant in the most severe circumstances is an important option for a CCP in managing a default. In order to limit the potential liquidity contagion, these powers should be clear for all market users, who in turn should have capabilities to defer settlement accordingly e.g. to their clients.

EXCHANGE OF VALUE

19. Where two obligations are linked, e.g. currency markets, CCPs need not link settlement if the risk is adequately controlled by other risk management measures.

Currently the proposed CPSS-IOSCO standards require Delivery versus Payment (DvP) or Payment Versus Payment (PvP) as the only means of settling transactions. However CCP12 members believe that even in an exchange of value settlement system, elimination of Principal Risk by linking the final settlement of one obligation to the final settlement of the other need not be insisted upon if the risk is managed adequately through other robust risk management measures. Therefore, if risk management for a settlement system is adequate, absence of PvP or DvP mode of settlement need not by itself make the CCP's settlement system non-compliant with the standards. CCP12 members have noted that delivery settlement conventions in foreign exchange and commodity markets preclude DvP or PvP but the risks have been successfully managed by CCPs.

PARTICIPANT DEFAULT

20. CCP12 welcomes CPSS-IOSCO's recognition of the limitations placed on CCP default management activities by local insolvency legislation and is strongly supportive of the direction provided to regulators by the Standards to address this issue urgently.

All CCP12 working group members have expressed a view that their existing domestic insolvency law and/or associated legislation are likely to inhibit their default management capabilities. Many point to the difficulties in managing

the Lehmans default as an example of the difficulties encountered. In particular, a large number of CCP12 members consider that changes are needed to local legislation to provide the degree of certainty needed for 'guaranteed' portability. Such legislative changes would appear to be consistent with the public interest policy objectives described elsewhere in this document.

Key to CCPs' needs is the recognition that CCPs should receive as a critical piece of financial markets structure in preserving systemic stability. In order to avoid the potential for an administrator or other insolvency practitioner from challenging a CCP's actions in closing out and transferring client positions, CCP's rights should be given primacy in the event of a default.

It is important to note, however, that even with an appropriately robust insolvency law, practical considerations may yet frustrate the ability to transfer out a defaulter's positions.

21. CCPs must retain flexibility in their default management activities and therefore need to ensure that the requirement for the public disclosure of intentions does not limit their potential actions or expose the CCP to excessive risk of legal challenge to the CCP's actions.

Whilst CCPs accept the broad need for transparency over their activities, the Principles must recognise the legal risks that such transparency may create, especially on complex variable activities such as default management. It is important that CCPs retain the flexibility achieved through their wide-ranging Rulebook powers that provide them with the capability of applying the optimum approach to the particular circumstances of any default. Therefore, any public statements that imply a particular behaviour within that framework potentially limits the CCP's reaction to a default and/or increases the possibility of a successful challenge to actions that have been taken to manage the default

SEGREGATION AND PORTABILITY

22. CCP12 urges CPSS-IOSCO to carefully consider the commercial impact and potential unintended consequences on CCP users of portability requirements where the CCP is required to each hold Clearing Participant's client margin, on a gross basis, at the CCP.

Principle 14, key consideration 2, states that "A CCP should employ an account structure that enables it readily to identify and segregate positions and collateral belonging to customers of a participant." This can be understood in a way that "identify and segregate" implies that all assets have to be segregated. This is (if intended) undesirable as certain clients would not necessarily require segregation – i.e. the level of segregation should be the

client's choice. Clients should be free to choose to opt-out of client protection regimes. Where a client chooses segregation, the CCP has to identify and segregate positions and collateral in an omnibus or individual account. It is important that customers have the choice between different protection levels offered by the CCP. Thus, choice means that not only protection aspects, but also cost aspects have to be considered.

Even if mandated - in the absence of such a legal or regulatory segregation requirement - it needs to be considered that CCPs usually are not in a position to monitor adequately if their market participants would segregate positions and collateral belonging to customers accordingly. It needs to be the responsibility of regulators and supervisors ensuring that such rules are applied by the participants.

Segregation and especially portability requires not only the national law of the CCP to support its required arrangements. In order to guarantee legal certainty with regard to segregation and portability arrangements, different national laws for all relevant jurisdictions urgently need to be aligned. Especially the complex and heterogeneous insolvency laws in Europe make a standardized and cost effective client protection offering very difficult for CCPs. The same complexities arise for CCPs offering their services both in the US and Europe.

CCP12 members support CPSS-IOSCO's objective to improve position portability as a way of improving default management capabilities in the event of a Clearing Participant default. In order to achieve this objective many members are of the view that portability could only practically be achieved through gross margining of client positions and lodging margins with the appropriate CCP.

The impact of these actions on many Clearing Participants, however, will be significant given that many clearing participant business models are very reliant on the interest earned on client margin balances. Removing this source of participant revenue is likely to see some firms exit the industry, increasing CCP concentration risk.

CCP12 recommends that CPSS-IOSCO to engage directly with market users to ascertain the impact of these changes to the wider market place.

23. Portability of client cash market unsettled transactions is impractical and should be excluded from the principle. The Principles should also recognise that portability of a significant number of retail client positions may be impractical in the necessary timescales for a CCP's management of a default.

Clearing Participants engaged in cash market trading often have a significant number of retail client positions. Given the substantial number of transactions

and short settlement timescales, transferring typically T+3 unsettled transactions is not practical for a CCP.

CCP12 members have identified that this problem may also extend to other defaults with large numbers of (retail) clients in markets such as equity options. In such circumstances, CCP12 notes the important role to be performed by non-CCP investor protection funds designed to protect retail investors from the impact of their broker/clearer's default.

GENERAL BUSINESS RISK

24. Proposed general business risk methodology of 6,9 or 12 months is too simplistic and national regulators should be permitted to determine appropriate amounts based on the CCPs approved internal models.

CCP12 members accept the objective of holding capital against general business risks but consider that such a simple approach does not properly reflect the cost of winding down a CCP business. Many CCPs already employ their own models for 'non-default' capital requirements and these should be reviewed by the relevant regulatory authority. Where approved, the results could be used to determine the appropriate capital requirement.

Such a simplistic risk mitigation approach also does little to inform CCPs of the sources of their risks. In the absence of such models, CCPs requirements should be based on six months of operating expenses. CCP12 members note that CCP operating expense definitions may be complicated and establishing the risks solely attributable to a CCP may be complicated by other activities undertaken by the corporate group owning the CCP.

TIERED PARTICIPATION

25. CCP12 believes that the ability of CCPs to review risks associated with indirect participants and participant's default capabilities is impractical.

CCP12 notes that the expectation of a CCP Board regularly reviewing the potential risks arising from indirect participation and also of the CCP having adequate information of direct members' default handling process to deal with the default of large indirect participation would be at best very onerous and probably impractical. It will also be a question of interpretation as to whether the requirements are being adhered to. It is therefore suggested that compliance requirement with this principle should have adequate flexibility.

Further clarity is also sought from some CCP12 members on the purpose, scope and requirements of this principle.

Key Issues on which CCP12 Members' Views Vary

1. Severity of the stress testing credit event assumption for credit risk

The overwhelming majority of CCP12 members expressed support for the use of the single largest CP default test for credit risk. Two members prefer a test based on the default of the two largest participants.

The two largest Clearing Participant default test was considered by most CCP12 members to be too extreme, especially when combined with the extreme market price movements used in stress testing scenarios. Many CCP12 members noted that the existing largest default test was considered to be a sufficiently extreme event as there was no empirical evidence of the largest Clearing Participant ever defaulting, let alone at the same time as an adverse extreme price movement.

Many CCP12 members were concerned with the impact of such a change, believing that the two largest participant default scenario would burden CCPs and the markets they serve with potentially significant and expensive capital requirements for little enhancement in practice to a CCP's counterparty standing. Some members noted that CCPs already have a number of sources which provide early warning of counterparty weakness (such as credit ratings, CDS spreads and share price movements). CCPs regularly use such signals to effectively target counterparty risk by either reducing the size of exposure limits before Clearing Participants need to entirely collateralise positions, calling additional margin and/or increasing initial margin rates. These mechanisms were considered to provide a much more targeted approach to risk mitigation which does not burden CCPs and market users with unnecessary capital costs.

CCP12 members also outlined that if the default test is expanded to include affiliates then the affiliate definition will need to be better defined to provide greater certainty to FMIs. The affiliate definition ideally should include entities where a significant controlling equity interest is maintained, although some flexibility should be retained to ensure that the credit event scenario reflects likely 'co defaults'.

Two CCP12 members expressed a preference for credit risk stress tests to cover the default of the two largest CPs. These members supported this position because they view the default of two participants before replenishment of the CCP's financial resources to be a plausible scenario and it would be consistent with US proposals for Systemically-Important Derivatives Clearing Organisations (SIDCOs) and current EMIR provisions.

One of the CCP12 members feels that the possibility of simultaneous default by more than one participant is almost unlikely in cash market products. It

therefore feels that if more than one default is to be factored in, a distinction should be made between the type of product and the Local regulator should be given authority to decide on this aspect.

2. Severity of stress testing credit event assumption for liquidity risk

All but one of the CCP12 membership supported the default of the single largest Clearing Participant for liquidity risk stress testing. Many members came to this position due to reasons which were consistent with those put forward under the credit risk proposal. As highlighted in recommendation 18 above, it was also noted that this principle had strong connections to comments in other principles (e.g. settlement finality and default management). A number of CCP12 members outlined that the liquidity risk provisions on CCPs would be determined by the final position on these linked principles but that currently the potential impact of the combined interpretation was potentially enormous and more significant than the raising of the standards in respect to credit risk.

Many members questioned whether the availability of commercial liquidity lines was both feasible and/or sufficiently reliable. If such lines could be secured from commercial providers, it was noted that these facilities would probably be unavailable if the stress test scenario actually eventuated. Other members noted that their central banks would probably not be prepared to provide the necessary liquidity lines, at least not in the magnitude required.

Many CCP12 members noted that such liquidity lines would represent a significant cost for CCPs at only the largest CP default level, let alone at the potentially higher standard. These costs would need to be passed on to market users through a number of possible mechanisms including higher initial margins, larger default fund contributions and/or restrictions on the size of participant positions. It was also noted that the two largest CP default scenario would exacerbate the expected negative market impacts from the liquidity proposal including lower trading volumes, increased bid/ask offer spreads and generally higher trading costs for market users.

Some members noted that liquidity exposures tend to 'spike' for many equity cash market clearing CCPs around major contract and index expiries probably due to low risk arbitrage activities. Many members thought that supporting the largest participant default scenario was more appropriate because even this option would have a significant amount of funding inefficiency given that liquidity requirements need to be met at all times while liquidity 'spikes' are often infrequent. Mid-size, often national CCPs are particularly impacted by the proposals.

Some CCPs also supported the single largest CP liquidity default proposal as it would result in a lower increase in participant concentration risk. Under the two participant default scenario, even if adequate liquidity lines become available, more costs would need to be passed through to users and many

CCP12 members thought that the magnitude of these costs would probably force some participants to exit the market, increasing the CCP's concentration risk.

Another reason for selecting the single largest CP default scenario was that some CCPs were expecting to shortly commence clearing OTC derivatives. Some members thought that this market development could significantly increase the size of their liquidity risk requirements which may potentially make central clearing of OTC derivatives uneconomic.

One CCP12 member thought the liquidity risk stress test should incorporate the default of the participants with the two largest liquidity positions. This was primarily because the two largest clearing participant default scenario would maintain consistency with this member's preferred assumption for the two largest participant credit risk default.

3. Frequency of stress testing and back testing.

Most CCP12 members believe that stress testing should be undertaken daily, thereby ensuring ongoing compliance with the financial resource standards for credit and liquidity risk. Moreover, several members use the output from those calculations to call additional collateral from participants in some circumstances. The same CCP12 members questioned whether the formal backtesting of margins could be undertaken on a daily basis. Whilst they recognise that informal 'backtesting' of margin rate adequacy is undertaken at least daily through variation margin and often intraday through intra day margining, these members believe that formal model testing benefits little from the addition of one day's extra data.

One of the CCP12 member however agree with the suggestion under Proposed Principle 4 that Stress Test should be performed at least monthly or more frequently under circumstances as listed. It feels that running proper stress testing (including for liquidity) on a daily basis for a multi-product CCP is not feasible. It also feel that backtesting should be conducted daily to demonstrate that margin cover is at least 99% as suggested in the consultation document.

4. Use of contingent resources as CCP financial resources

CCP12 members were divided on the issue of contingent resources being acceptable as CCP financial resources. Some believe that the current CPSS-IOSCO guidance should continue, reflecting the strength of the Rulebook powers for contingent calls which in one case was established in domestic legislation. Ultimately, these members believe that the national regulator should make the final decision on the robustness of those powers in the event of a default.

Some CCP12 members hold the opposite view, that contingent resources could not be seen as sufficiently robust at times of stress to be viewed as part of a CCP's financial resources. Therefore they believe that the proposal should be adopted as proposed.

Most CCP12 members held a view that value should be given to contingent resources but that it should be less than 100% to reflect the possibility that the call may not be met and to create an incentive to use paid in resources where possible. By giving contingent resources a zero value, they argue, CCPs would be encouraged to discontinue their existing contingent resources powers.

5. Right of access to a CCP of organisations other than Clearing Participants

The majority of CCP12 members were content with the proposed standard granting access to other CCPs on all but risk management grounds. Some CCPs however expressed a view that only Clearing Participants should be members of CCPs.

6. Access to Central Bank Liquidity

Most CCP12 members have requested that the standards be updated to encourage central banks to support CCPs in maintaining systemic risk protections by permitting access to central bank liquidity on reasonable commercial terms. Given the potential impact of the liquidity and settlement finality provisions, some argue that this is a necessary step in order to comply with the standards as the provision of commercial bank liquidity lines is unlikely to be sufficiently robust at times of market stress. Furthermore, access to intraday central bank facilities are also beneficial on an intraday basis in overcoming short term payment delays and maintaining timely settlement of margins to all participants.

Other members disagree with this position, believing that commercial banks liquidity is robust and that the provision of liquidity support from central banks to CCPs is unlikely to be consistently applied, creating competitive issues between CCPs. In addition, these CCPs highlight the potential moral hazard of central bank support especially at times of market stress in a default where such liquidity support is almost equivalent to capital support.

7. Resumption of Systems Post-Disruption

One CCP12 member contends that the proposed resumption of operations within two hours of disruption with backups coming up instantly (3.17.3) is too ambitious.

CCP12 Executive Committee and Members

Executive Committee

Office-bearers (who also serve on the Executive Committee):

- **Chair:** Luis Jorge Pelayo, Indeval (Mexico);
- **Vice-Chair:** Siddharta Roy, CCIL (India);
- **Vice-Chair:** Marcus Zickwolff, Eurex Group (Germany)

Ordinary Executive Committee members:

- Rory Cunningham, LCH.Clearnet (UK);
- Takeshi Hirano, JSCC/TSE (Japan);
- Paul Jones, ASX (Australia);
- Kevin King, HKEx (Hong Kong);
- Dale Michaels, CME (USA);
- Johan Rudén, NASDAQ OMX (Sweden);
- Andrew Simpson, DTCC (USA);
- Luis Vicente, BM&F Bovespa (Brazil); and
- Mike Walinkas, OCC (USA).

Members

ASX Limited (ASX)

BM&F Bovespa (BM&F)

The Canadian Depository of Securities Limited (CDS)

Canadian Derivatives Clearing Corporation (CDCC)

Cassa di Compensazione e Garanzia S.p.A. (CC&G)

CME Group (CME)

The Clearing Corporation of India Ltd (CCIL)

Depository Trust & Clearing Corporation (DTCC)

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Hong Kong Exchanges & Clearing Ltd (HKEx)

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Japan Securities Clearing Corporation (JSCC)

National Depository for Securities S.A. (KDPW)

Korea Exchange (KRX)

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National Securities Clearing Corporation Limited (NSCCL)

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