



CPSS-IOSCO Consultative Document on
**Principles for Financial Market
Infrastructure”**

CCIL Submission

Response to Consultative Document on Principles for Financial Market Infrastructure, March 2011 : The Clearing Corporation of India Ltd, Mumbai, India

This refers to the March 2011 CPSS-IOSCO Consultative Document on **"Principles for Financial Market Infrastructure"**.

CCIL congratulates CPSS-IOSCO Working Group on creating a very comprehensive document dealing with various aspects of Financial Market Infrastructure(FMI) and in trying to harmonise the standards expected of these institutions. Perhaps for the first time, there is a document which brought the importance of FMIs and its inter-linkages to the financial markets into such sharp focus. The report has also highlighted the systemic implications of having a weak FMI in the financial market. CCIL is also delighted to observe from interactions with the members of CPSS-IOSCO Working Group that the Regulators are mindful of the possible cost implications of adhering to the higher standards being sought to be set and the likely impact thereof on the cost structure of the markets.

CCIL operates in India as a Central counter-party for OTC financial market products since 2002 as an authorized Payment & Settlement System Service Provider authorized by Reserve Bank of India, the central bank of India. It presently provides CCP clearing mainly for institutional trades in Government Securities, Foreign Exchange . US Dollar-Indian Rupee trades separately for trades in spot window and forward trades and trades in domestic money market through its own product Collateralised Borrowing & Lending Obligation (CBLO). It is also in the process of offering CCP settlement for Indian rupee denominated trades in Interest Rate Swaps by using the trade warehouse for such swaps developed by it.

Being a CCP offering clearing exclusively for last 10 years in OTC markets where netting efficiency and cost of margin and capital play very important roles in the decision making of the settlement participants in using or otherwise of the CCP services, it feels that the current G 20 approach of encouraging CCP clearing through incentives and mandates can go a long way in making the markets safer. As G 20 stance is in turn being pushed forward by the forums of various Regulators, it is natural that issues about safety and security in dealing with CCPs, systemic implication of a CCP failure, CCP's access to Central Bank liquidity and its treatment like a bank etc. will be debated. The subject of current consultation therefore can have a significant bearing on the final outcome of the efforts to have CCP clearing for settlement of OTC trades, mostly derivative trades. As OTC markets help thrive innovation and it is not possible to let the market be stifled only by controls alone, it is imperative that all stakeholders together work for a fair, secure and agile market infrastructure. CCIL therefore was delighted to see that the document has covered all major types of market infrastructures. It however feels that as Anonymous Trading Systems play a very important role in OTC markets and standards of their deliveries hold a key to the safety and security of the market and the CCPs are increasingly looking towards these for getting their business, it would have been ideal to include such systems in the group of FMIs.

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The document also seeks to put in place the expected standards of Trade Warehouses. CCIL is a pioneer in development of Trade Repository in Indian rupee denominated Swap trades. The Repository was started in August 2007 and the data stored in the Repository came in very handy for the Indian Regulator to quickly facilitate closure of the outstanding swap trades of the Lehman entity in India post-Lehman bankruptcy. Data stored in this Repository is used to provide cash flow settlements to the swap market participants and would soon be used for starting CCP clearing in the swap market as stated above. It is felt that the standards sought to be imposed will go a long way in standardizing practices in Trade Repositories across the world. CCIL is of the view that while interoperability between CCPs will be difficult to come by, interoperability between Trade Repositories could be achieved relatively easily giving the market and regulator the transparency that it badly needs in today's environment.

The coverage of the consultation is extensive and in the absence of how the assessment standards would be set, it was very difficult to arrive at an informed and considered decision. CCIL however tried its best to provide its responses based on the current understanding which may need to be modulated as the assessment standards become available. In many cases, CCIL's responses are therefore not as specific as it would like those to be.

CCIL feels that the document gives an impression that the principles laid down there are mandatory in nature. The approach also assumes that one size fits all and that there is only one correct solution. Most principles do not also offer any flexibility or leeway. The reality is that the markets in developing countries are very different from the markets in developed countries. Even markets in developed countries are in different stages of development and are battling with legacy issues. For example, in some of the developed countries, commercial banks seem to be capable of providing secure settlement services to the CCPs and dependence on the Central Banks for settlement is considered to be minimum. RTGS is also run privately and security settlement systems allow intra-day liquidity to CCPs for settlement (either through self collateralization or through any other means). On the other hand, in the developing world, it is usually not possible to offer secure settlement otherwise through the Central Bank run settlement systems. In such cases, intra-day collateralized liquidity to the CCP from the liquidity provider in the settlement system (usually Central Bank itself) is a necessity for efficient functioning of the market. CCPs in those markets should not be denied the intra-day liquidity of this type (i.e. for settlement) based on moral hazard related consideration.

The developing countries usually have another peculiar problem. Their markets are usually dominated by one or two major banks. The CCPs based in such countries would always find it difficult to meet liquidity stress test requirement, if it is to be assumed that such banks are in default and the default leads to complete repudiation of settlement liability. Positions would look much more acute if the settlements are predominantly cash market settlement and the extent of default

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is treated at 100%. These large banks many a times are required to keep huge amounts as Cash Reserve with Central Bank itself and to keep liquid assets as Liquidity Reserve. It is therefore necessary in such cases to factor in these available resources as mitigating factors.

CCIL is also of the view that if some of the Principles and Key Considerations are considered as minimum international standards, those should be clearly specified in the document. Other principles should allow some flexibility where national Regulators can exercise their judgment. The Explanatory Notes should provide background and guidance to the national regulators and other stakeholders.

Considering that too many of the issues are involved and there are a number of areas where vagueness exist, CCIL feels that a further period of consultation should be allowed after the initial views are included in the document. This will ensure that the conclusions would be more meaningful and appropriate.

In respect of the recommendations under specific principles, CCIL's responses are as under:

Principle 1: Legal Basis : Cross border legal inconsistencies can put a CCP operating simultaneously in various jurisdictions under serious difficulty in the times of stress. Variation in insolvency related legislation across jurisdiction is a very critical issue. CCIL feels that a general legal framework across the jurisdictions for ironing out the differences in laws in various countries on the lines of Model Code on Bankruptcy put in place by Unicitral would be desirable.

CCIL strongly supports the idea that high degree of certainty of legal basis for each aspect of an FMI's activity should be ensured.

It also feels that if any deficiency is sought to be covered through alternate risk management measures, the efficacy of the measure should be reviewed by the MFI at least annually in consultation with its Regulator.

Principle 2 & 3: Governance & Framework for Management of Risk: Risk governance : Recent crisis has clearly shown that the governance deficit could be the most important issue in ensuring safety and security of the FMIs and the markets. CCIL therefore strongly supports the recommendations in this regard.

CCIL also suggests that the FMIs, as far as possible, be owned by the Users and these should be a not for profit entity. For FMIs which are not so structured, independent directors should have adequate say in management of the company to ensure that any undue risk is avoided.

Principle 4 : Credit Risk : CCIL is of the view that resource coverage of default of a single entity on which the CCP would have largest exposure should be considered adequate. In the absence of any empirical data of default beyond this

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limit, hiking the requirement to cover two largest exposures will have significant cost implication without any reliable basis. As the resources to a CCP mostly come from its clearing participants, any additional resources collected from them will lead to their having higher exposure on the CCP. Basel Committee has already recommended that this exposure be considered for assessing capital requirements. Thus, increase in exposure of clearing participants on CCP on this account would not appear to be justifiable.

CCIL strongly supports the recommendation that backtesting for demonstrating margin adequacy needs to be a daily process as recommended in para 4.3.11 and stress testing can be a monthly or more frequent process as recommended in para 4.3.12. Stress Test however should be run for Settlement Bank exposures as well. Moreover, CCPs should share its Stress Test Results in a summarized manner to all Clearing Participants (including indirect participants). Such disclosure should not include any reference to positions of any individual or any group of clearing participant.

In para 3.4.13 of the recommendation, peak historic volatilities have been sought to be included. CCIL feels that if there has been significant change in market structure since the event and there is a unanimous view supported by the local regulator that such historic volatility is improbable in the changed market scenario, such event need not be considered.

Reverse Stress Test may also not be very meaningful in case of multi-product CCPs. On the other hand, it may cause unnecessary scare amongst its stakeholders. CCIL therefore suggests that this recommendation should be kept as best practices.

Principle 5 : Collateral: CCIL feels that only tangible collaterals should be considered. Bank Guarantee/Letters of Credit not meeting the standard suggested in footnote 44 cannot be treated as collateral. Banks also follow this norm in their classification of loan assets and this is reasonable.

In regard to the recommendation in para 3.5.3 to have %haircuts incorporating stressed market condition, CCIL feels that the approach would be improper and would have consequences which might not have been intended. While the suggested course of action seeks to provide protection against a sudden stress in the market (may be once in 5 years) and provides the clearing participants the comfort that the value of their collaterals placed as margin will not go down in any significant manner, it creates significant additional exposures of the Clearing Participants on the CCP. This will be totally avoidable if the Clearing Participants can be periodically alerted by the CCP as to what may happen in case of stress in the market scenario.

Principle 6 : Margin: CCIL is fully supportive of this recommendation. It however is apprehensive that the frequent references to Stress Test under this principle

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may lead the national regulators to take a view that margins should cover Stress losses. The principle that the margin is not expected to cover stress losses needs to be upheld clearly to ensure cost effective clearing and also to ensure that the exposures of the Clearing Participants on the CCPs do not increase unduly.

Principle 7 : Liquidity Risk: CCIL would like to point out that same day close out or hedging in case of a default will not be feasible under many circumstances. It is therefore necessary that the arrangement between the CCP and its clearing & settlement participants to reschedule defaulted payment should be recognized for the purpose of liquidity plan.

Moreover, assessment of adequacy of liquidity in case of settlement failure of the clearing & settlement participant, need not assume that there would be 100% failure, especially for cash market products. For example, a large bank as settlement participant where settlement is in Central Bank money and the participant is required to keep cash reserve of huge value with the same central bank, a default unlikely likely to precipitate funds shortage of total amount. The funds shortage will only be for a fraction of the amount payable. Similarly, for a securities settlement system settling say securities of 1500 types and a settlement participant having obligation in 100 securities, it will be unreasonable to consider shortage in all 100 securities for modeling purposes.

Principle 8 : Settlement Finality: CCIL supports the recommendation

Principle 9: Money Settlement : While CCIL agrees with the recommendation in this regard, it feels that this principle should recommend that CCPs should be encouraged to conduct money settlements in their own books. CCIL feels that an orderly money settlement in this manner will reinforce risk management when margining is on portfolio basis.

Principle 12: Exchange of Value System: The recommendation is for Delivery versus Payment (DvP) or Payment Versus Payment (PvP) as the only safe means of settling transactions. CCIL is running a Foreign Exchange (Indian Rupee/US Dollar) settlement system which does not operate on PvP basis. However, the risk control adopted through other risk management measures like settlement netting of very high order, setting limits, collecting margins, having well defined and clearly understood shortfall and loss allocation mechanism has allowed CCIL the residual risk to be brought down to almost insignificant level. CCIL therefore strongly feels 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.

Principle 14: Segregation and Portability: While CCIL supports the direction, it feels that the legal impediments and cost consideration would come in the way

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of achieving the standard of segregation to the level sought to be achieved. It feels that a more appropriate approach would be to allow the indirect participants to seek the level of protection they consciously decided to have. The authorities also should be encouraged to make necessary legal changes in their jurisdictions.

Principle 15: General Business Risk : While CCIL supports the approach in principle, the amount of capital that an FMI should be required to hold should be decided by the FMI in consultation with its national regulator.

Principle 16: Operational Risk: The recommendation that an FMI should be able to resume operations within 2 hours following disruptive event with back up systems commencing processing immediately do not seem to be always achievable. Some leeway should be provided depending on the scale of the disruptive event.

Principle 19 : Tiered Participant Arrangement : While CCIL believes that it is a step in right direction, FMIs, more particularly CCPs, will take time to adjust to this reality. CCIL believes that this requirement will help in ensuring systemic stability in a better manner by throwing open potential problems well in time.

Principle 20: FMI links : Links between CCPs will present totally new type of challenges for CCPs in Counter-party Exposure management and in Default handling. This will require free flow of related information between the linked CCPs. For the safety of market, controlling regulators should periodically review the effective control and functioning of the arrangement.

Links between TRs would be necessary for making the data available to the stakeholders in a meaningful manner. Counter-party and market exposure related information would be of critical importance. It should therefore be important to encourage TRs to allow access to other TRs and form collaborative endeavors. A recommendation to this effect would be beneficial.

CCIL thanks the CPSS-IOSCO Working Group for allowing it an opportunity to offer its comments. It would be willing to provide to CPSS-IOSCO Working Group any clarification on its responses that may be required. CCIL would also consider it a privilege to work with the group or any of its sub-group/members to examine any other aspect of CCP or TR related issues.

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