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Via email: cpmi@bis.org and consultation-2016-01@iosco.org

18 October 2016

Dear Sir/Madam,

Response to CPMI-IOSCO Consultative Report on Resilience and Recovery of Central Counterparties (CCPs): Further Guidance on the PFMI

The Alternative Investment Association Limited[1] (**AIMA**) welcomes the opportunity to submit its comments on the Committee on Payments and Market Infrastructures (CPMI) and the Board of the International Organization of Securities Commissions (**IOSCO**) (**together, CPMI-IOSCO**) consultative report on *Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI* (**the Consultation Paper**). Our members are substantial users of central counterparty (**CCP**) clearing services for both exchange-traded and cleared over-the-counter (**OTC**) derivative contracts, and their demand for such services will increase as the respective G20 jurisdictions mandatory clearing initiatives take effect and incorporate a broader range of contracts. As significant users of CCPs, our members are exposed to the risk of losing their positions and posted collateral if a CCP fails, even though our members are indirect CCP participants, who access a CCP as a client of a clearing member.[2]

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,700 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

[2] In this letter, we use the term ' clients' to mean the buy-side participants that undertake a contractual relationship with a clearing member that enables the relevant buy-side participant to clear derivative contracts indirectly with the relevant CCP.

Overall, we support the development of further guidance on robust measures and a consistent underlying framework to avoid the failure of any systemically important financial market infrastructure (**SIFMI**) in the first instance and, should failure nonetheless occur, to enable the orderly, fair and transparent resolution of such SIFMI without recourse to taxpayer funding.

In respect of the key sections of the Consultation Paper, we have provided comments below on the CPMI-IOSCO further guidance within the Consultation Paper specifically in relation to governance, coverage, CCP contribution to losses and recovery planning.

Governance

In principle, the use of appropriate resilience and recovery measures (in conjunction with relevant resolution planning and tools) may well be valuable in both avoiding and mitigating the harm of residual failure risk. We, nonetheless, stress that the practical application of such tools must occur in a fair and predictable manner in order to prevent disproportionate burdens from being placed on certain categories of clearing participant; in particular, to avoid allocating losses inadvertently on end investors, which are often the taxpayers that the initiative is seeking to protect. As clients of clearing members, AIMA members require robust protection of their own clients' assets. Accordingly, we are concerned that the current Consultation Paper continues to assume the use of collateral haircuts as a tool for a CCP board to limit the effects of procyclicality. In our view, the use of such a tool disproportionately places a liquidity burden on participants with directional in-the-money positions with the CCP. Such participants are likely to be firms or persons, for example, using derivative contracts to hedge derivative positions held with another CCP, hedge other investments or exposures or take directional positions in relation to an underlying security or other referenced factor. The imposition of collateral haircuts during a period of financial stress may result in such participants closing their positions, further exacerbating market conditions. In this regard, we are concerned that a CCP board is unlikely to be in a position to take a market-wide helicopter assessment of the potential wider impacts of collateral haircuts, including understanding the full extent of interdependencies between positions held by single market participants across a number of CCPs.

Furthermore, CCPs already have an artificially dominant position in the market due to the roll-out of mandatory central clearing of OTC derivatives, thus are subject to reduced competitive forces that incentivise cutting-edge best practice and efficiency regarding risk management. Counterparties are compelled to use their services if they wish to trade a particular mandatorily clearable contract. By enabling customer money to be used by a CCP through haircuts of client VM (or IM) to limit the effects of procyclicality and preserve its ongoing viability, the CCP's risk and reward profile would be dangerously skewed, potentially leading to a reduced focus by owners and management on risk management and operational best practice.

Overall, we support the level of transparency and disclosure proposed in the Consultation Paper with regard to the CCP board's development and oversight of the CCP's stress-testing framework and results, its margin system methodologies and the decisions regarding the amount and characteristics of its own financial resources exposed to losses. This transparency will be key for asset managers in conducting ongoing due diligence for their customers. However, we suggest that a CCP board should also be required to provide maximum transparency with regard to the financial health of a CCP implementing its recovery tools, for both direct and indirect clients. Transparency is a key factor in maximising voluntary participation by clients for as long as possible during a period of financial distress and, upon signs of the CCP's return to health, encouraging a swift return of any clients that ceased participating. In this regard, AIMA suggests that CCP participants must be provided with sufficient information to be confident that: (i) the CCP will continue to operate normally so that delays or other inconveniences are not experienced; and (ii) their VM gains will not be at risk of an arbitrary haircut. We, therefore, strongly recommend that regular detailed and reliable information is given to CCP participants as to the financial health of the CCP to which they are exposed in order for the recovery initiatives to be given the greatest chance of proving successful.

Lastly, while the Consultation Paper considers key responsibilities of a CCP's governing body, it does not consider whether the current balance of representation within a CCP's governance framework is appropriate. While EMIR requires that a CCP risk committee includes client representatives, we believe this should be a global mandate. The fact that clients will be impacted by a CCP failure, may bear losses, or may be required to contribute to the recovery of a CCP via margin haircuts underscore the need for buy-side participants - as clients of CCP clearing members - to have affirmative and meaningful representation on CCP governing bodies (in particular, CCP Boards, Risk Committees and Default Management Committees). In the absence of such a mandate, we are concerned that CCPs may not adequately take into account the views of all market participants. In this regard, our members have reported to us that it is readily apparent which CCPs have higher levels of buy-side representation in their governance bodies, with a clear correlation to higher levels of trust and confidence in those CCPs.

Coverage

AIMA notes that it is impossible and economically unrealistic for a CCP to maintain sufficient pre-funded resources to enable it to withstand every tail-risk eventuality. A balance must be reached between the: (i) the likelihood of extreme tail-risk events that could threaten the viability of a CCP notwithstanding compliance with EMIR prudential rules; (ii) the systemic costs associated with the disorderly failure of a CCP bearing in mind the level of uncovered losses that would likely result; and (iii) the additional costs of clearing associated with such extra buffers.

In the EU, CCPs are already subject to strict prudential standards that require extensive amounts of capital to protect against multiple CM failures and operational issues that occur in extreme but plausible market conditions. We appreciate that these buffers are not cheap to maintain, with the respective costs passed on to clients in the form of additional clearing fees. We, therefore, recognise that extra pre-funded buffers beyond those maintained by an EMIR-compliant CCP to cover all truly exceptional and highly unlikely tail-risk events, such as the failure of a third or fourth CM, would make clearing so expensive as to become economically unviable.

We support the level of transparency proposed in the Consultation Paper with respect to a CCP's approach to determining the largest exposures. We also support high levels of disclosure, consistency and predictability that should follow from clear procedures and rules being put in place by CCPs to return to minimum coverage amounts, where this has been breached.

CCP contribution to losses

As a general concept, we agree it is important that the CCP itself is exposed to the loss of its own funds as part of the default waterfall so that its interests are harmonised to the greatest degree with the interests of its participants to avoid default. It is also important that CCPs accept a high level of responsibility for non-default losses, reflected in the order of non-default loss allocation. This also aligns with prudential rules for capital, CM margining and default funds under Chapter III of EMIR, which are designed to mitigate risks posed by CMs to the CCP. It may be helpful, however, to reflect in the guidance that there are different ownership structures across CCPs and this will need to be factored into any exercise of assessing non-default loss allocation and the corresponding alignment of incentives across key stakeholders, including owners and managers.

As a separate measure for consideration, AIMA also broadly supports the principle of obliging CCPs to issue a minimum quantum of bail-inable instruments as a 'recovery' tool to complement the EMIR default waterfall with additional internal resources. In our view, such 'skin-in-the-game' has important benefits both by providing an additional layer of capital protection, but also ensuring that CCPs have a significant mutual interest with their participants of ensuring robust risk management.

Recovery planning

AIMA supports the development of robust and tested CCP recovery plans to ensure there is consistency and predictability during periods of financial stress. There are, however, a number of additional points we believe should be addressed in the guidance.

First, while we accept that assessment rights could well be a useful recovery tool in recovery, we believe the guidance should require that a pre-agreed cap is established with respect to assessment rights. In our view, it would have undesirable systemic consequences to expose CMs to potentially unlimited liabilities as this would result in higher regulatory capital charges being levied on such participants, which in turn, would likely be passed on to clients in the form of more expensive clearing.

AIMA also supports a number of additional recovery tools being considered in the context of CCP's recovery plans in addition to the already robust standard CCP default waterfall. These tools include issuing bail-inable instruments (discussed above); the use of (re)insurance contracts by the CCP to cover any unallocated losses at the end of the default waterfall; and extending participation in auctions to the buy-side. We believe these additional tools would achieve a relatively small but sufficient additional layer of contingent protection to the CCP to enable it to continue to operate during periods of significant financial distress and, perhaps most importantly, avoid margin haircutting thus give clients sufficient confidence in the CCP's financial conditions so that they continue participating voluntarily during a period of financial stress. We suggest that the contingent and relatively small amount of protection we propose should not make clearing excessively expensive.

With regard to the use of insurance contracts, we note that this would provide an additional layer of risk supervision, with the insurance provider having a commercial interest in the soundness of the operational and risk management practices of the firm. Furthermore, the insured amount would not be excessively large, being at the end of the default waterfall, and would also be extremely unlikely to be called upon. Accordingly, we would not expect the cost of such insurance to materially increase the costs of clearing (although this would need to be explored further) and, in these circumstances, we support such a measure being considered.

And lastly, as mentioned above, AIMA also recommends that, in order to maximise participation in CCP auctions of the unmatched positions of defaulted CMs and the likelihood that these unmatched positions obtain new counterparties, CCP auctions should be open to both buy-side and sell-side participants under pre-determined criteria. Moreover, increasing the number of buyers in an auction by permitting clients to participate would increase competition and likely result in higher auction bids and sales.

If you have any questions or would like to discuss any aspect of this response in more detail, please contact Jiří Król (jkrol@aima.org) or Adele Rentsch (arentsch@aima.org).

Yours sincerely,

Jiří Król
Deputy Chief Executive Officer
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