clear to trade

Eurex Clearing AG

Comments

CPSS-IOSCO consultative report

Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs, May 2010

Frankfurt am Main, 21 June 2010

Eurex Clearing AG
Neue Börsenstraße 1
60487 Frankfurt/Main

Mailing address:
60485 Frankfurt/Main

Internet:
www.eurexclearing.com

Chairman of the Supervisory Board:
Prof. Dr. Peter Gomez

Executive Board:
Andreas Preuß (CEO), Jürg Spillmann (Deputy CEO), Dr. Thomas Book, Gary Katz, Michael Peters, Peter Reitz

Aktiengesellschaft mit Sitz in Frankfurt/Main
HRB Nr. 44828
Amtsgericht Frankfurt/Main

A. Introduction

Eurex Clearing AG welcomes the opportunity to comment on the May 2010 consultative report, “Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs,” of the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO).

Eurex, one of the world's largest derivatives exchanges, provides an extensive range of products including some of the world's most heavily traded derivative contracts. Eurex has always been at the forefront of electronic trading and serves the derivatives industry globally with access to the benchmark futures and options market for European derivatives.

Eurex Clearing, a central counterparty clearinghouse (CCP), is a subsidiary of Eurex providing central clearing services for cash and derivatives markets both for listed as well as certain over-the-counter (OTC) financial instruments. Eurex and Eurex Clearing actively contribute to market safety and integrity with state-of-the-art market infrastructure both in trading and clearing services as well as with leading risk management processes for the derivatives industry. Customers benefit from a high-quality, cost-efficient and comprehensive trading and clearing value chain.

B. Comments

General Comments

The consultative report correctly highlights the pivotal role played by CCPs with regard to the stability of financial markets. It notes that well-designed CCPs with appropriate risk management arrangements reduce systemic risk through effectively reducing and managing counterparty risks, creating transparency on positions, and helping to ensure the operational efficiency of the market. As such, CCPs contribute to maintaining market confidence and liquidity in times of stress and facilitate the goal of financial stability.

In the wake of the default of Lehman brothers in September 2008, this stabilizing role was validated. As one of the largest OTC and exchange-traded derivatives players, Lehman was the counterparty on numerous derivatives contracts. In the case of centrally cleared derivatives, CCPs achieved a near-complete resolution for all open positions within less than 15 trading days. Additionally, CCPs were able to effectively shield the accounts of market participants trading through Lehman from the effects of its bankruptcy. In this way, CCPs mitigated market disruptions and prevented spillover effects, thus minimizing risks to all parties involved.

Global regulators and policymakers have recognized the stabilizing function of CCPs and have launched multiple initiatives to encourage an increase in the use of CCPs, especially for OTC derivatives. Most notably, this policy goal was highlighted in the G20 Leaders’ Statement from September 2009: “All standardized OTC derivative contracts should be …

cleared through central counterparties by end-2012 at the latest"[1] and reemphasized in more recent statements. In the EU, implementation of this policy goal is underway through proposed legislative measures including the Derivatives and Market Infrastructures Legislation and adaptations to the Capital Requirements Directive, among others. In parallel, these initiatives as well as additional initiatives—such as this CPSS-IOSCO consultation—have been launched with a focus on ensuring that CCPs are equipped to handle the anticipated increases in volumes and complexity.

As one of the largest CCPs globally, Eurex Clearing welcomes the setting of strong operational and risk management standards for CCPs. However, we wish to emphasize the importance of policymakers not losing sight of the primary objective to increase the safety of the market through increasing the share of OTC derivatives cleared through CCPs. Carefully designed incentives to this end are still required.

Furthermore, it is important that these multiple initiatives remain aligned to ensure that CCPs are subject to clear and non-duplicative regulation.

Comments on Proposed Guidance on Application of RCCP to OTC Derivatives CCPs

As an overall comment, it is important to note that adherence to the proposed guidance could require in certain cases additional resources and changes to existing procedures, but in most cases appears to be appropriate and will help to ensure safe and efficient CCP clearing of OTC derivatives. Furthermore, much of the proposed guidance will be appropriate for CCPs clearing any product and not just OTC derivatives products. Likewise, existing CPSS-IOSCO Recommendations will also be relevant for OTC derivatives.

Recommendation 1: Legal risk

The guidance makes reference to industry standards and market protocols that apply to CCPs clearing OTC derivative products and notes that OTC derivatives CCPs need to be transparent about the role of such standards and protocols in their rules, procedures and contracts. Particular reference is made to ISDA protocols.

Eurex Clearing agrees that industry standards and market protocols form an important part of the CCP clearing service. However, in some cases strict adherence by the CCP is not possible, for example in the case of default procedures as defined in ISDA documentation. Our approach is to reference the respective protocol in the clearing condition and adjust where required.

In this regard, it is important that CCPs are involved in the relevant ISDA committees that discuss and create the market documentation as described in this section of the guidance. Such involvement allows the CCP to ensure that specificities and requirements of CCPs

1 See Leaders' Statement, Pittsburgh G20 Meeting, available at: http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

are appropriately addressed and allows the CCP to make possible necessary changes in clearing conditions.

Recommendation 2: Participation requirements

The guidance makes reference to the need to ensure that for non-regulated entities (described in Guidance 2.1 as “e.g. buy-side entities such as hedge funds or large corporates”) admitted to participate in an OTC derivative CCP, risks should be appropriately mitigated by participation requirements and other appropriate measures. Specific risk management measures are described.

In large part, current practices for customers of general clearing members (GCMs) or direct clearing members (DCMs) of CCPs for listed derivatives can be extended to OTC derivatives. In the case of listed derivatives, market participants without a clearing license as a GCM or DCM clear transactions via a GCM or company-affiliated DCM. The clearing member is then obliged by the CCP to demand margin amounts from its customers which are at least as high as the levels that result from the CCP’s method of calculation or to apply other risk management approaches such as appropriate credit management policies. The CCP has an audit right to ensure these conditions are met. The CCP can always limit its exposures towards a certain participant by setting more stringent limits on trading and risks.

In the view of Eurex Clearing, the audit right of the CCP is sufficient and the proposed requirement for the non-regulated entity to obtain external certification of operational capacity on an ongoing basis would be excessive and could lead to prohibitive costs for the entity.

Recommendation 3: Measurement and management of credit exposures

The guidance covers the need for a thorough understanding by the CCP of the unique characteristics of OTC derivatives products, the availability and reliability of pricing data for risk management, and concentration risk.

With regards to price data, we would highlight that post-trade transparency for derivatives and in particular OTC derivatives, for example as being considered under the MIFID regime, can significantly increase the quality of clearing as the CCP has better price transparency not only once a day but during the day. This enables a CCP to do “continuous and timely” valuations based on real market prices, as is already the case with listed derivatives.

With regards to guidance on changing procedures to extend operating hours, it should be considered that in cases where adequate up-to-date pricing or evaluation facilities are ensured for calculating portfolio risk exposures, there is not a need to extend operating hours.

Recommendation 4: Margin requirements

The proposed guidance covers models and methodologies considering unique characteristics of OTC derivatives products, liquidation assumptions for OTC derivatives products, and portfolio margining.

Eurex Clearing agrees that this proposed guidance is appropriate and will help to ensure safe and efficient CCP clearing of OTC derivatives.

Recommendation 5: Financial resources

The proposed guidance covers financial resources available to cover losses to an OTC derivatives CCP and contribution allocations of these financial resources.

Eurex Clearing agrees that this proposed guidance is appropriate and will help to ensure safe and efficient CCP clearing of OTC derivatives.

Recommendation 6: Default procedures

The proposed guidance covers ex ante arrangements for surviving participants' active role in the default procedures, management of large positions in less liquid products in the default procedures, governance over the implementation of default procedures, segregation and transfer of customers' positions and collateral, and periodic testing of default procedures.

With regard to default procedures, we appreciate the fact that the guidance acknowledges multiple options. These include an auction participation obligation as well as other approaches such as hedging strategies. We would welcome the report making clearer that the approach of entering into a macro-hedge to manage the risk of a portfolio of a defaulting participant is one option and not a required alternative or complement to an auction participation obligation or other default procedures. In fact, macro-hedges can in fact lead to additional complications, as described in the guidance report already. Although the practice may be standard in some markets, it should not be expected to be adopted as standard practice across all markets.

With regard to segregation, Eurex Clearing welcomes that the guidance explicitly states that CCPs can only endeavour to transfer customer positions and collateral but that applicable laws might not permit this transfer. Furthermore, it is important that the guidance recognizes that the transfer should not compromise the safety of the CCP and its non-defaulting participants. Transfer of customer positions and collateral must remain at the discretion of the CCP in order to ensure the integrity of the clearinghouse.

Recommendation 8: Operational risk

The proposed guidance covers operational risks associated with links, scalability to provide links to other venues, and global issues.

Eurex Clearing agrees that this proposed guidance is appropriate and will help to ensure safe and efficient CCP clearing of OTC derivatives.

Recommendation 12: Efficiency

The proposed guidance covers accommodating needs of different market participants, efficiency implications of links, and efficiency implications on decisions to clear new products.

Regarding efficiency implications of links, Eurex Clearing agrees that CCPs should be able to decide on basis of their risk management requirements whether to grant access to trading platforms to the services of the CCP.

Regarding offering new products to clear, CCPs should be obligated to explore clearing feasibility from a risk management perspective. Key factors include: (a) valuation—the possibility of automatic valuation (i.e. sufficient liquidity); (b) closeout possibility—in case of insolvency/default, close-out of position (i.e., liquidation) possible; (c) standardization—sufficient standardization to ensure a fully transparent contractual position at any point in time, to ensure positions are automatically identifiable, and utilizing a consistent set of terms (e.g., notional value, counterparty, up-front payment, interest rate, duration); and (d) enforceable legal claim.

Regarding other analysis, CCPs can provide some indications of margin and fund amounts to enable participants to calculate their own costs, for example simulations of potential margin requirements resulting from synthetic portfolios or real portfolios provided by a clearing member. It is difficult for a CCP to assess cost effects on specific members as a CCP does not have access to the internal (cost) structures of its diverse member structure.

For analysis regarding overall market effects, such as systemic risk reduction, the relevant regulator or supervisor should be responsible. A CCP does not have an overview of the existing and expected market exposure before it is entered into the clearing system. This implies that any analysis by CCPs regarding impact on systemic risk reduction would be very much assumption based.

Recommendation 13: Governance

The proposed guidance covers representation of relevant stakeholders, emergency situations, expansion of product and participant scope, and the CCP's role in developing industry standards and protocols.

Regarding representation of relevant stakeholders, Eurex Clearing welcomes the particular references to the benefits of giving consideration not only to direct participants but also indirect participants. Eurex Clearing has a forum in place to involve participants in discussions to ensure development of the most appropriate new functionalities and services, e.g., on risk management as well as on the addition of clearing services for new products. We would welcome expanding such groups to include also indirect participants and independent experts, believing this will further contribute to ensuring that the needs of the market are met. However, it should be ensured that, given potential conflicts of interest, such governance structures continue to serve an advisory function while decision-making power—for example on risk management or clearing services for new products—remains with those responsible for risk management within the CCP.

With regards to industry standards and protocols, Eurex Clearing agrees that these form an important part of the CCP clearing service. However, in some cases strict adherence by the CCP is not possible, for example in the case of default procedures as defined in ISDA documentation. Our approach is to reference the respective protocol in the clearing condition and adjust where required.

The guidance makes specific suggestions regarding credit event determinations. Eurex Clearing agrees that an observer role within the ISDA Credit Derivatives Determinations Committee would be beneficial, but that CCP representation is not required. Furthermore, instead of a CCP having its own Determinations Committee, in our view the more effective approach would be that CCPs, although not direct ISDA members, would have the right to request the ISDA Determinations Committee to solve a credit event / succession event.

Recommendation 14: Transparency

The proposed guidance covers the need for further market transparency and service transparency requirements.

Regarding market transparency, Eurex Clearing agrees that the recent financial crisis has highlighted the lack of transparency on transactions in OTC derivatives markets. In particular, Eurex Clearing agrees with the report's assessment that CCPs are well placed to enhance the transparency of the markets they serve. The information provided by CCPs to regulators and supervisors on centrally cleared transactions should be complemented by information provided on non-CCP cleared OTC derivatives transactions provided to trade repositories. Eurex Clearing has provided further input on this topic through its comments to the parallel CPSS-IOSCO consultative report on trade repositories. We note that it will of course be important that discussions currently underway in multiple forums—including trade repositories discussions as well as transaction reporting requirements and transparency requirements—that will have an impact on reporting and transparency are aligned.

Recommendation 15: Regulation and oversight

The proposed guidance covers common reporting.

Eurex Clearing agrees with the report's guidance on common reporting formats. In case of a CCP being active in multiple markets, the home regulator should have the lead in supervision, and the service offering in different countries should be performed on the basis of passporting. As a consequence, reporting should be provided once to the home supervisor who takes care to distribute to any host supervisor being involved.

Comments on General Considerations for Clearing OTC Derivatives Products

As described under our comments to the guidance provided under Recommendation 12, key factors in the assessment of clearing feasibility include: (a) valuation—the possibility of automatic valuation (i.e. sufficient liquidity); (b) closeout possibility—in case of insolvency/default, close-out of position (i.e., liquidation) possible; (c) standardization—sufficient standardization to ensure a fully transparent contractual position at any point in time, to ensure positions are automatically identifiable, and utilizing a consistent set of terms (e.g., notional value, counterparty, up-front payment, interest rate, duration); and (d) enforceable legal claim. We very much welcome the recognition that it is not possible to have a tick-box approach with concrete requirements for each of the factors listed, but that rather an overall assessment must be conducted that integrates the relevant factors in a flexible way.

Considering these factors, we believe that more than 60% of current derivatives volumes could be considered feasible for clearing. The 40% likely ineligible for clearing would include highly complex structures and certain simple structures where transparent pricing would not be available. Through efforts toward standardization and further pricing transparency, the proportion of clearing-feasible derivatives could be further increased.

With regards to a clearing obligation, we believe that in order to meet global objectives to increase centralized clearing of OTC derivatives, further standardization would need to be pursued where possible. For example, if a certain product (group) is relevant or becomes relevant from a systemic risk point of view, standardization should be pursued in order to increase liquidity and allow fair and transparent pricing to provide a basis to centrally manage the risks of such products, i.e. allow CCP clearing. Such standardization efforts should be fulfilled through a joint effort of market participants, CCPs, and relevant regulators and supervisors.

If a product (group) does not fulfil the criteria outlined in the "general considerations," such products should be subject to correspondingly higher capital requirements / bilateral collateral requirements reflecting the higher risks implied. With respect to decisions regarding the appropriate level of capital requirements / bilateral collateral requirements, regulators should consider additional risks associated with factors outlined in this section of the guidance.

Regarding availability of price information of the product, a post-trade transparency requirement for OTC derivatives would increase the quality of clearing and central risk management.

C. Conclusion

We hope that you have found these comments useful and remain at your disposal for further discussion.

For any further details or clarifications, please contact:

Marcus Zickwolff
Head of Department, Eurex Trading and Clearing System Design, Eurex Clearing AG

Marcus.Zickwolff @ eurexchange.com

Ingrid Vogel
Market Policy & European Public Affairs, Deutsche Börse AG

Ingrid.Vogel @ deutsche-boerse.com