



FEDERATION
BANCAIRE
FRANCAISE



25 June 2010

CPSS-IOSCO

GUIDANCE ON THE APPLICATION OF THE 2004 CPSS-IOSCO RECOMMENDATION FOR CENTRAL COUNTERPARTIES TO OTC DERIVATIVES CCPs

-

CONSULTATIVE REPORT

-

RESPONSE OF THE FRENCH BANKING FEDERATION (FBF) AND THE ASSOCIATION FRANÇAISE DES MARCHES FINANCIERS (AMAFI)

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, i.e. more than 500 commercial, cooperative and mutual banks. FBF member banks have more than 25,500 permanent branches in France. They employ 500,000 people in France and around the world, and service 48 million customers.

The Association française des marchés financiers (AMAFI) has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.

Both associations above welcome the opportunity to comment on the CPSS-IOSCO consultation. These comments are in addition to the comments previously made by FBF and AMAFI, on CESR public consultations (ref: CESR/08-749 and CESR/09-302) which are still relevant.

* *
*

General Remarks

FBF and AMAFI welcome the opportunity to respond to the consultation « *Recommendations for Central Counterparties to OTC derivatives CCPs* » since its members are very involved in this activity.

As general remarks, we would like to underline our agreement on most of the recommendations listed by CPSS-IOSCO in this consultative report. In that way, FBF and AMAFI also share the aim of limiting the systemic risk through the implementation of OTC

derivative CCPs since the financial crisis shows the paramount importance of this kind of infrastructures to prevent such risk.

However, FBF and AMAFI would like pointing out the following comments which are, on their opinions, not fully developed or missing in this consultative report.

First, FBF and AMAFI are of the opinion that CCPs should be ideally a regulated entity with a banking status limited to its clearing activity. If, in some jurisdiction, the banking status is not possible, therefore the CCP should be subjected to similar rules in order to ensure the required level of robustness capable of preventing any systemic risk event. This status should specify that:

- CCPs must have intraday access to the central bank money,
- CCPs should have the same standards as banks for resolution,
- Liquidity and capital requirements should be aligned with those applicable to the banking sector.

In fact, this consultative report does not evoke the important question of the CCPs access to the relevant central bank liquidity. We strongly believe that a CCP should always be in a position to rapidly and securely obtain the necessary liquidity for it to limit systemic risk, as provided by the monetary policy. In the event of a major financial crisis, central banks had a major role to play in order to solve the crisis. In case of default of one of its participants, the CCP needs to be able to access to the liquidity provided by a central bank as rapidly as possible (on an intraday or overnight basis). In this context, the CCP must have a direct link with the central bank which seems difficult if it is not under its supervision.

Secondly, as it will be highlighted in our comments on the following guidance 8.2, FBF and AMAFI are not in favour of interoperability between CCPs since we consider it as a major element of distribution of systemic risk. Furthermore, the European experience shows the complexity of its implementation which may lead to slow down the constitution process of CCPs.

Thirdly, the collateral and the way to treat the segregation of assets and the re-use possibilities, which are a central importance to prevent systemic risk, are not addressed in this consultative report.

Fourthly, it should be borne in mind that this consultative report only addresses CCPs for OTC derivatives. Its rules should be then clearly distinguished from those applicable to other securities settlement systems. Central counterparties for OTC derivatives are one of four types of infrastructures (with payment systems, securities settlement systems and trade repositories). Each infrastructure should focus on its particular type of risk. E.g. CCP absorbs counterparty risk. That means that (i) CCPs should not be allowed to take other forms of risk (credit risk) and should limit other risks they take (market risk, operational risk) and that (ii) provisions on specific types of risk cannot be generalised throughout different types of infrastructures.

Our detailed response follows.

Recommendation 2: Participation requirements

Regarding participation requirements, the paper should be more specific in order to ensure a robust and high level of risk management within CCPs:

- As the draft recommendation puts it, participants of regulated entities in a CCP should have sufficient financial resources and robust operational capacities. This is a major issue for CCP as such infrastructure will always be as weak as the weakest of its –direct– members. In other words, direct eligibility to a CCP should be reserved to the best counterparties. For this reason, other criteria should be added to select CCP members, such as the rating of the counterparty and its capital ratios.
- Regarding participation of non-regulated entities, the consultation paper rightly points out that their participation in a CCP can present challenges to the risk management of a CCP. From a systemic point of view, as the CCP risk management procedures will be designed to cope with the risk of default of one of its members, instead of requiring such entities to post additional upfront collateral or external certifications, we would recommend not having any non-regulated entity as direct members of a CCP. Instead, the possibility should be left to non-regulated entities to join the CCP through an indirect access (i.e. using the access of a member). That would need to specify appropriate rules regarding the segregation and portability of assets.
- Each direct participant should have the capability (in terms of financial and operational resources) to assist in the risk management framework of a CCP in a stress environment (e.g. a member default) to encourage both liquidity (in the sense of being able to unwind quickly and efficiently the positions of the defaulting participant) and portability (so positions of indirect participants held via the defaulting clearing member are portable to other non-defaulting clearing members). Guidance 2.2 reflects this; 2.1 less so.

Therefore, due to the risk incurred by the community of the clearing members in the event of default of a member, FBF and AMAFI are of the opinion that access to CCP should be limited to regulated entities. Hence, non regulated entities should only be indirect participant.

Recommendation 3: measurement and management of risk exposures

FBF and AMAFI agree with the necessity for a CCP to regularly measure its credit exposures to its participants.

However, the measure of the “*concentration risk*” as set out in guidance 3.3 needs to be more precisely defined since it seems difficult to measure what exactly is a highly concentrated market exposure.

On this matter, we consider that the creation of specific “expert committees”, integrated within the risk committee and specialised for each type of OTC derivative may be of some interest in the determination and measure of each relevant concentration risk.

Recommendation 4: Margin requirements

FBF and AMAFI agree with the necessity that “*models and parameters used in setting margin requirements should be risk-based and reviewed regularly.*”

The margin call review should be made through an external committee, composed with representatives of clearing members and independent experts.

This could avoid discretionary calculation of these margins.

Finally, a CCP should have a limited right to reuse collateral.

Recommendation 5: Financial resources

The recommendation should clearly point out that dedicated guarantee fund must be installed for cash-equity and derivatives clearing.

Recommendation 6: Default procedures

We globally agree with principles set out in this recommendation on “*default procedures*” since they appear as common rules necessary to strengthen a CCP. Default procedures shall be then, as described the consultative report, “*transparent and understood by all participants*”.

Recommendation 8: Operational risk

We understand through this recommendation, and its guidance 8.2, that CPSS-IOSCO promotes the implementation of interoperability between CCPs.

As mentioned above, we are not in favour of such interoperability for the following reasons.

First of all, implementation of interoperability is difficult, as evidenced by the fact that, in the European area, after about 3 years of work done by the banking and financial industry and monitoring of the Code of Conduct by the European Commission, interoperability links have not yet been implemented, despite multiple demands. Since the market infrastructures have published access and interoperability guidelines, more than 80 demands have been issued but none has as yet been put in place.

This can be attributable, amongst other things, to the following reasons:

- The complexity of building interoperability links between CCPs due to obstacles that would prevent competition from taking place on an equal footing ;
- The multiple differences that exist for the respective CCPs, representing public sector barriers: variety of national, legal requirement and some regulatory obstacles brought forward by regulators and supervisors; as well as private sector barriers ;
- The players have realized that answering to all requests for access and interoperability would result in implementing an inextricable network of links that could lead to a kind of spaghetti network.

Secondly, the development of interoperability between CCPs could lead to a facilitation of systemic risk propagation between interconnected CCPs, which lead the opposite result reached through the promotion of implementation of CCPs for the clearing of OTC derivatives.

Recommendation 13: Governance

Regarding governance issues, FBF and AMAFI are of the opinion that the representatives of the clearing members should be involved in default management according to a clear and transparent operational process.

Considering guidance 13.1, we think that the guidance is too imprecise and ambiguous (*a CCP's governance arrangements should be designed in such a manner that they give due consideration to the interests of different types of its participants (include indirect participants), to broader stakeholders with direct and indirect interdependencies with the CCP and to the CCP's unique role in the market*). Indeed, we must draw a line between:

- The governance of the CCP that should be ensured by entities assuming the risks within the CCP, i.e. the clearing members.
- The role of the indirect participants that should be able to express their views and therefore be represented in the appropriate bodies of the CCP, though without being able to decide on the CCP risk management matters. It is our opinion that a “*proportionality principle*” should be established between the level of responsibility and the level of involvement of each clearing members not to create asymmetric situations.
- The reference of the “*broader stakeholders with direct and indirect interdependencies*” is definitely too broad (it could include trading platforms, settlement systems as well as competitors) and could lead to potential conflicts of interests between those stakeholders and the governance of the CCP. This reference should therefore be removed.

Recommendation 14: Transparency

It seems important to ensure that these rules are consistent with those formalized for trade repositories.

While we acknowledge that CCPs can have a role in market transparency, we believe that such an issue goes largely beyond the scope of its technical paper on CCPs and should be analysed together with the consultation on Trade Repositories. There could be limited added value in having the same requirements on post-trade transparency for CCPs and trade repositories as the latter will cover a broader scope than the former and the need for such duplication is not obvious.

Regarding the pre-trade transparency role that a CCP can play, we should bear in mind that pre-trade transparency is generally recognised as being excellent across OTC derivatives and that data relating to specific risk-transfer transactions would normally be considered commercially confidential. Due regard should be had for any impact on the ability of the market to function in the first place and the position of intermediaries whose capital is at risk every time they enter a transaction as principal.

Recommendation 15: Regulation and oversight

Regarding regulation and oversight issues, it is our opinion that such regulation should be treated at the level of the law, and not on contractual criteria to ensure that those rules and conditions will be broadly accessible.

Annex 1: General considerations for clearing OTC derivative products

The question of product eligibility needs to be addressed: CCPs determine product eligibility under supervision of its regulator. We favour a "*clear or explain*" approach, i.e. for products which the regulators anticipate would be "*clearable*", either CCPs propose a solution to clear new products (that will then be "*eligible*" for clearing) or explain to regulator why this is not possible.

Annexe 2: Detailed guidance on CCP emergency actions and market protocols

Regarding the point 3 developments with respect to "*the expectations for CCPs to limit the economic impact emergency actions*" (see page 32 of the consultative report), principles described in this point 3, specifically in its paragraph 2, should comply with common principles usually admitted by countries in their insolvency laws.

In that sense, any liquidation windfall obtained through insolvency proceedings may not be directly sent to surviving participants, as the administrator of the defaulting member should receive those windfalls first (subject to any security interest over such recoveries in favour of the defaulting member's clients).