The Committee on Payment and Settlement Systems (CPSS)
The Technical Committee of the International Organization of Securities Commissions (IOSCO)

29 July 2011

Dear Sirs,

**Consultative Report: "Principles for financial market infrastructures"**

LCH.Clearnet Group Limited ("LCH.Clearnet" or the "Group") is pleased to respond to the request for feedback on the progress report on the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions ("Committees") Consultative Report: *Principles for Financial Market Infrastructures*.

LCH.Clearnet is the world's leading clearinghouse ("CCP") group. It was formed out of the merger of the London Clearing House Limited and Clearnet SA, and operates two central counterparty clearinghouses or CCPs, LCH.Clearnet Limited in London[1] and LCH.Clearnet SA[2] in Paris. The Group's CCPs serve major international exchanges and platforms, as well as a range of over-the-counter ("OTC") markets; they clear a broad range of asset classes, including cash equities, exchange-traded derivatives, metals, energy, freight, interest rate swaps, bonds and repos.

The Group applauds the progress that is being made towards implementation of the G20 commitments, in particular the encouragement of central clearing for OTC derivatives.

In light of the important role that clearinghouses play and the increased reliance that the G20 commitments place on them, we believe that it is of paramount importance that CCP prudential standards are set at a high level. We also believe that prudential standards for clearinghouses should be set globally and that enforcement of such standards is upheld in all jurisdictions in which such infrastructures operate. CCPs must be conservative and must not compete on initial margin, or in any way be incentivised to lower risk standards.

We applaud the Committees' work in this regard, and welcome the opportunity to comment on these important matters. We would urge the Committees to ensure that the development of these important standards leads to convergence at the highest level and not to a lowest common denominator compromise.

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[1] LCH.Clearnet Ltd is regulated by, *inter alia*, the Financial Services Authority of the United Kingdom and by the Commodity Futures Trading Commission (as a "Derivatives Clearing Organization") of the United States.

[2] LCH.Clearnet SA is regulated as a Credit Institution and Clearing House by a regulatory college consisting of, amongst others, the market regulators and central banks from: France, The Netherlands, Belgium and Portugal. It is also regulated as a Recognised Overseas Clearing House by the UK Financial Services Authority.

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## Credit and Liquidity Risk

We urge the Committees to adopt a "cover two" requirement as the global minimum credit and liquidity risk coverage standard for all CCPs, irrespective of their size and the products that they clear. Furthermore, we believe that these coverage levels should be based not only on the counterparty or two counterparties that generate the largest exposures, but also to the exposures of their affiliates.

## Procyclicality

The Group understands the potential impacts of procyclical margin adjustments and for this reason it has mechanisms in place that smooth any increase in protection that market conditions require. The Group does, however, stress to the Committees that the avoidance of procyclical margin adjustments must be secondary to a CCP's maintenance of adequate margins and collateral. An example of a mechanism that addresses this challenge is the Sovereign Risk Framework used by LCH.Clearnet for both Fixed Income margins and margin collateral haircuts. Under our framework, incremental margins and haircuts are applied in a predictable manner as issuer credit deteriorates. The framework ensures not only that participants can continue to access liquidity as stress increases, but also avoids sudden and unexpected procyclical changes.

## Risk Management

The Group believes that CCP Risk Management standards must be calibrated to the highest level. A strong governance function should enforce the risk tolerances articulated by CCP Boards. As identified in the Committees' Governance Principle, a key part of the governance function is the establishment of CCP Risk Committees. We fully agree that CCPs should establish Risk Committees and ensure that these Committees are chaired by sufficiently knowledgeable independent board members. We do not, however, believe that CCP Risk Committees should consist of a majority of independent members. Instead, CCP Risk Committees should be comprised of expert risk representatives from CCP participants and markets served by CCPs, together with CCP risk and senior management personnel.

## Global Convergence

Although the Committees are still consulting on CCP risk and governance standards, detailed rule proposals have already emerged from the CFTC and the Securities and Exchange Commission ("SEC") in the US. Similarly, the European Market Infrastructure Regulation ("EMIR") enters into detailed matters of risk management (e.g. the scaling of a CCP's default fund) that could possibly differ from both the US rules and the Committees' final Principles.

We call upon the Committees to take a leadership role in harmonising these rules so as to ensure the greatest possible degree of regulatory standardisation globally. This extends to a standardisation in treatment of CCPs for capital and margin requirements, whether such CCPs have chosen to adopt bank status or not. Harmonisation at the highest level is essential to avoid any increase in systemic risk. The alternative, one of regulatory inconsistency and institutional fragmentation, may introduce more risk into the global financial system, increase the cost of supervision and compliance and, potentially, encourage regulatory arbitrage, thereby undermining the G20 commitments and the Committees' important work.

**CCP Resolution**

Another matter of critical importance to the fulfilment of the commitment to extend central clearing further into the OTC derivatives markets remains unaddressed. Understandably, the drive to require CCPs to clear more instruments, in particular OTC derivative instruments, is fuelling concerns in some quarters that the next generation of "too-big-to-fail" institutions is being created. For this reason, we would encourage the Committees to address globally the resolution of CCPs and other systemically important financial infrastructures as a matter of priority.

In recognising that this work will require further intensification of international regulatory co-operation, we are concerned that no timetable has yet been set for the Committees to issue guidance on sound cross-border oversight arrangements for Financial Market Infrastructures. Again, we would urge the advancement of this important workstream.

**Conclusion**

We hope that the Committees find the above comments, together with the more detailed commentary set out in the attached annex, to be helpful and constructive. We believe that the depth of our experience, combined with our OTC market expertise and the wide geographic scope and deep product breadth of our activities, makes us uniquely well-qualified to comment on these standards.[3]

LCH.Clearnet, as the world's pioneering OTC derivatives CCP group, fully shares the G20's and the Committees' goals in ensuring a stable, safe and efficient global financial system and looks forward to continuing its participation in the policymaking debate. Please do not hesitate to contact us should you have any questions on our submission, or if you would like to discuss any of the matters raised in greater detail.

Yours faithfully,

P.P.
**Ian Axe**
**Chief Executive Officer**

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3 The Group works closely with market participants and exchanges to identify and develop services for new asset classes, particularly in support of OTC derivatives market reforms. Already, LCH.Clearnet Limited clears more than 50% of the OTC interest rate swap market representing trades with a total notional principal of over $295 trillion in 17 currencies, whilst LCH.Clearnet SA cleared more than €42 billion notional value in OTC credit default swaps over the last year.

## Annex

LCH.Clearnet supports the views expressed in the submissions of the Associations of which it is a member (including CCP12 and EACH) but would like to take this further opportunity to make some more specific comments and re-emphasise certain points - in particular those relating to the questions posed in the Committees' cover note[1] to the Consultative Report dated 10 March 2011.

**Section 1** LCH.Clearnet Group's Answers to the Questions set out in the Cover Note to the Consultative Report

**Section 2** LCH.Clearnet Group's detailed comments on the Principles, Key Considerations and Explanatory Notes

[1] http://www.bis.org/publ/cpss94covernote.pdf

## Section 1

**Principle 4 Credit Risk**

1. *What are the pros and cons of establishing for credit risk (1) a "cover one" minimum requirement for all CCPs; (2) a "cover two" minimum requirement for all CCPs; and (3) either a "cover one" or a "cover two" minimum requirement for a particular CCP, depending upon on the risk and other characteristics of the particular products it clears, the markets it serves and the number and type of participants it has? What potential risk, competitiveness or other concerns might arise if certain CCPs that clear certain products would be subject to a "cover one" minimum requirement, while certain other CCPs that clear certain other products would be subject to a "cover two" minimum requirement? How and to what extent could these concerns be addressed?*

   <u>The Group believes a "cover two" requirement should be adopted as the global minimum credit risk coverage standard for CCPs</u>.

   We do not believe there would be any justification for having differing standards for CCP credit risk and CCP liquidity risk: as such, there should be a "cover two" requirement, for both credit *and* liquidity risk.

   We would also stress that the coverage should be based not only to the counterparty or two counterparties that generate the largest exposures, but also to the exposures of their affiliates.

   As we stated in our covering letter, we support any effort that leads to a global harmonisation of prudential standards for CCPs at the highest level. Such requirements would support this.

   Finally we would stress that these standards must be applied to *all* CCPs, irrespective of the size and scope of their activities – and irrespective of which products they clear. In this regard we would observe that both the EMIR[2] proposal for the regulation of CCPs in Europe and the rules proposed by the CFTC for systemically-important DCOs[3] require coverage of the two largest exposures for credit risk.

   **<u>For all the reasons set out above LCH.Clearnet supports the development of CCP credit and liquidity risk coverage standards at the "cover 2" level.</u>**

2. *Which risk and other characteristics of the products cleared by a CCP are relevant in weighing the pros and cons of a "cover one" versus a "cover two" minimum credit requirement for a CCP? In particular, to what extent are any or all of the following product and market characteristics relevant: OTC versus exchange-traded; mandatory versus voluntary clearing; "cash" versus "derivative"; the duration, volatility and degree of leverage; the number and type of CCP participants; the degree of market concentration; and the availability and reliability of prices from continuous,*

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2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF
3 http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-25322a.pdf

As stated above, the Group believes it is of paramount importance that these standards apply to all CCPs irrespective of the product and market characteristics. We do not believe that any of the items listed above would either (a) affect the probability of default of the largest or two largest counterparties, or (b) require that such coverage be set at different levels.

**Principle 14 Segregation and Portability**

1. *What are the different models and approaches to establishing segregation and portability? What are their pros and cons respectively, for example in terms of efficiency and level of protection that can be achieved? In view of the different options and models that may exist, is there any one option or model in particular that could usefully serve as a minimum requirement? Would it is be possible to identify a specific approach to segregation and portability that could be defined as best practice? Would it be helpful to distinguish between different types of customers, such as by the degree of tiering or by domestic or cross-border activity? Please explain. Would it be helpful to distinguish between different types of products? If so, please explain why and how. What are the existing legal constraints that limit segregation and portability?*

The Group believes that the optimal model for delivering the client-level protections sought both by regulators and by investors and other indirect clearers, is that which has been set out by the CFTC in its Proposing Release[4] of 9th June 2011 - *Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions*.

Without doubt, the "Complete Legal Segregation" model is the most appropriate model for ensuring efficient and effective client level protections and portability.

Under this model, the collateral of all cleared customers of a member of a CCP is held on an omnibus basis, but such collateral is attributed to each customer based on the collateral requirements set by the CCP with reference to each customer's positions. In this way, the value of each customer's collateral is protected from the default of all other customers of the clearing member and, if the customer ports, from that of the clearing member itself.

**<u>The Principles should therefore require all CCPs providing OTC derivatives client clearing services to offer legal protection at the individual client level.</u>**

The Group would additionally recommend that CCPs providing OTC derivatives client clearing services should be *permitted* to offer both client omnibus structures *and* full physical segregated accounts. Finally, we would recommend that CCPs clearing products other than OTC derivatives should be required, at a minimum, to offer client omnibus account structures (wherein the "customer" risk is separated from that of the member or house account). Such a requirement would be in line with the provisions set out in both the EMIR proposal and the CFTC's proposed rules.

4 http://www.gpo.gov/fdsys/pkg/FR-2011-06-09/pdf/2011-10737.pdf

**Principle 18 Access and Interoperability**

1. *In this Section the CPSS and IOSCO specifically request comment on the future evolution of global clearing structures and the role that interoperability may have in this regard, as well as on the challenges associated with establishing links between Financial Market Infrastructures.*

As the Committees correctly observe, the introduction of mandatory clearing and the integration of international financial markets will increase the importance of ensuring fair and open access to FMIs and to CCPs in particular.

LCH.Clearnet strongly supports fair and open access principles for both direct and indirect participants, and fully concurs with the Committees' recommendation that any restrictions on such access must be justifiable only in terms of specific issues impacting the safety and efficiency of a CCP or other FMI, or the markets that they serve. **Restrictions on CCP membership should be limited to risk, operational and financial standards and, where appropriate, to members' preparedness to assume proportionate risk sharing responsibilities.**

On linkages between CCPs, the CPSS and IOSCO acknowledge that links are an important source of additional operational and financial risks, which call for more stringent requirements. The Group's CCPs have interoperated with other CCPs and believe that such arrangements, where these are limited to suitable products, and are constructed on well-founded legal bases that support the design, ongoing operation and prudential robustness of the two CCPs and their members, can deliver significant efficiencies. Notwithstanding this, it is the Group's firm and considered view that whilst such arrangements have proven to work well in a number of product areas (cash equities, for example), they will not necessarily transport to other more complex risks.

**The Group has strong reservations about interoperable links between CCPs clearing long-dated and or complex or illiquid OTC derivatives.** We would therefore urge the Committees to ensure that the final Principles do nothing to compromise a CCP's ability to manage such risks nor, indeed, to force one CCP to accept the risk of another.

We would further observe in this regard that certain markets, such as the foreign exchange and interest rate derivatives markets are both global and relatively complex in nature. In our view it will be more efficient and systemically safer for one or two CCPs to offer global clearing services for these markets, than for these markets to become bifurcated or balkanised by the advancement of multiple regional CCPs.

## Section 2

**Principle 3 Framework for the comprehensive management of risks**

***An FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.***

Key considerations

2 This states that "*A FMI should provide appropriate incentives and, where relevant, the capacity for its participants and their customers to manage and contain their risks vis a vis the FMI*."

Whilst LCH.Clearnet agrees that CCPs should provide such incentives and such capacity to its participants, CCPs cannot extend these to the clients of its participants. For this reason, we recommend deleting the words 'and their customers'.

Explanatory Notes

3.3.3 *This Explanatory Note states that: "The FMI's policies, procedures, and controls serve as the basis for identifying, measuring, monitoring, and managing the FMI's risks and should cover routine and non-routine events, including the inability of a participant to meet its obligations."*

Whilst we fully agree that CCPs must ensure they have robust policies, procedures and controls, it must be remembered that CCPs have no real powers over their participants' behaviours. CCPs can, and should, impose risk-based incentives on their participants and such incentives should seek to reinforce the 'defaulter pays' principle which requires that participants should bear the cost of risk they introduce into the system.

**<u>Principle 4</u>** **<u>Credit risk</u>**

***An FMI should effectively measure, monitor, and manage its credit risk from participants and from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. A CCP should also maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/ two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions.***

<u>Key Considerations</u>

5. *A CCP should determine and test regularly the sufficiency of its financial resources by rigorous back-testing and stress testing. Back-testing should be conducted daily to demonstrate sufficient initial margin coverage with a 99 percent degree of confidence. Stress tests to check the adequacy of the total financial resources available in the event of a default in extreme but plausible market conditions should be performed at least monthly, or more frequently when the products cleared or markets served in general display high volatility, become less liquid, or when the size or concentration of positions held by a CCP's participants increases significantly. In addition, more routine daily or weekly stress testing in which a CCP stresses the current positions of its participants using established parameters and assumptions should be considered to be a best practice. Comprehensive stress tests, involving a full validation of models, parameters, and assumptions and reconsideration of appropriate stress scenarios, should be conducted at least annually.*

LCH.Clearnet agrees that back-testing should be used as a tool to provide authentication to the margin algorithm a CCP uses. We also agree that back-testing should be conducted daily, however we believe that the review period should be set to a specific period and that this should be set, at a minimum twelve-month period.

We also believe that back-testing should be conducted both on specific products *and* at a portfolio level.

We concur with the requirement that comprehensive stress tests involve "a full validation of models, parameters, and assumptions and reconsideration of appropriate stress scenarios". The Group would urge particular emphasis be put on global convergence on the underlying principles to ensure full consistency in such measures and requirements.

*6. In conducting stress testing, a CCP should consider a wide range of relevant stress scenarios, including peak historic price volatilities, shifts in other market factors such as price determinants and yield curves, multiple defaults over various time horizons, simultaneous pressures in funding and asset markets, and a spectrum of forward-looking stress scenarios in a variety of extreme but plausible market conditions. The stress-testing programme should include "reverse stress*

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*tests" aimed at identifying extreme market conditions for which the CCP's financial resources would be insufficient.*

Again, the Group concurs with the Committees' requirements for stress tests. In particular, we support the forward-looking nature of the stress-testing required, as well as the use of 'stress-to-destruction' or reverse stress tests.

<u>Explanatory Notes – Credit Risk in CCPs</u>

3.3.8 *This Explanatory Note sets out how CCPs should mitigate their credit risk.*

We agree with the examples set out in the explanatory notes, but would observe where CCPs should not be restricted to making intra-day variation margin calls only when participants positions are loss-making. Rather CCPs should have the full and unrestricted ability to manage and mitigate credit exposure, including controlling their potential future exposure, both through intra-day initial margin and though variation margin calls. CCPs need such unrestricted rights in order to minimise intra-day exposure and control potential future exposure.

3.4.9 *This Explanatory note specifies that "Initial Margin should meet an established single tailed confidence level".*

In the Group's view this Explanatory Note would be more effective if the Committees provided more clarification on the meaning of "single-tailed confidence level" as it does not seem appropriate in the context of a CCP's risk management which by definition has to cover both "tails". We would also recommend that the Note provide more guidance on what it understands to be an "appropriate time horizon" for the close-out of defaulting members' positions.

3.4.10 *In this Explanatory Note the Committees should have additional resources to cover potential stress scenarios identified in regular and rigorous stress testing that should include, but not be limited to, the default of the [one/two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s].*

As stated in the preface to this Annex, the Group believes that there should be a single global standard for CCP credit risk coverage. This should be set at the "cover two" level – and the same requirement should be set for CCP liquidity risk coverage.

3.4.11 *This Explanatory Note specifies the approach that CCPs must take when back-testing*.

We strongly support the development of a global standard for CCP back-testing, however we believe that for such a standard to be meaningful, it must also specify the time horizon against which the back-tests are performed. In the Group's view the time horizon must be set at a least one year, if the tests are to be meaningful.

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**<u>Principle 5</u>** **<u>Collateral</u>**

***An FMI that requires collateral to manage its or its participants' credit risk should accept collateral with low credit, liquidity, and market risk. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.***

<u>Explanatory Notes</u>

3.5.2 *In this Explanatory Note the Committee sets out collateral acceptability considerations for CCPs.*

The Group generally concurs with these considerations and provisions, particularly the suggestion that CCPs should have in place suitable monitoring programmes for possible wrong-way risks.

This said, the proposal states that CCPs should not accept collateral with wrong-way risk; in our view this will not always be viable, as domestic participants in a CCP serving domestic markets are likely to provide collateral in local currency or with locally issued government debt securities. For this reason we would encourage that this be recommendation – but not a requirement.

CCPs should be required to monitor the potential for adverse wrong-way risk, but only be required to act if credit conditions pose an unacceptable level of such risk. *(See our answer to 3.6.9 for more detail on our approach)*.

3.5.5 *This Explanatory Note sets out how CCPs might limit Procyclicality. Specifically, it says: "an FMI should establish stable and conservative haircuts that are calibrated to include periods of stressed market conditions in order to reduce the need for procyclical adjustments."*

The Group agrees with the underlying intent – namely that CCPs should not add to procyclicality. We also concur with the requirement that haircuts be set conservatively. Notwithstanding this, it is of paramount importance that CCPs are able to adjust haircuts (and change margins) according to market conditions and without limitation. We believe that the best means of minimising concerns about procyclicality is by ensuring that CCPs are transparent and predictable, thus enabling CCP participants to adjust their behaviour.

By way of example of how a CCP might actively avoid making sudden procyclical adjustments, the Group has made participants aware of its Sovereign Risk Framework[5] as applied to margin collateral haircuts, under which incremental changes are made to haircuts as issuer credit deteriorates. This not only smoothes increases in haircuts, but also follows a publicised framework and makes adjustments according to publicly available market information.

[5] Published at http://www.lchclearnet.com/member_notices/circulars/2010-10-05.asp

**Principle 6** **Margin**

***A CCP should cover its credit exposures to its participants for all products through an effective margin system that is risk-based and regularly reviewed.***

Key considerations

1 *A CCP should establish margin levels that are commensurate with the risks and unique attributes of each product, portfolio, and market it serves, taking into account potential increases in liquidation times in stressed markets.*

We believe that the Key Consideration laid out above is inconsistent with that laid out in Key Consideration 3. It should be made clearer that margin levels should be based on normal market conditions and not stressed market conditions.

3 *A CCP should adopt initial margin models and parameters that are risk-based and generate margin requirements sufficient to cover potential future exposure to participants in the interval between the last margin collection and the close out of positions following a participant default. Initial margin should meet an established single-tailed confidence level of at least 99 percent for each product that is margined on a product basis, each spread within or between products for which portfolio margining is permitted, and for each clearing member's portfolio losses. The model should also be based on adequate time horizons for the close out of the particular types of products cleared by the CCP, have an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products, and, to the maximum extent practical and prudent, avoid the need for destabilising, procyclical changes.*

LCH.Clearnet has a number of observations on this Key Consideration.

Firstly, in our experience, using a 99% 'single-tailed' confidence level will create different margin levels for long and short positions and, further, it will be inherently less conservative than if absolute figures were used, i.e. if a large price increase is given equivalent weight to a large price decrease.

Secondly, we believe that unless both the associated time horizon for close-out *and* a definition of the distribution needed to create the confidence level are actually specified, this standard will lead to very significant divergences amongst CCPs. In turn this could conduce toward CCPs competing on the interpretation of the standard, and hence on margin levels.

Finally, we believe that for CCP margin models to be truly effective, the models also need to capture qualitative events, back-testing results and price movements. Qualitative events cannot be captured by setting a hard and fast 99% confidence level as this merely reflects an empirically risk-based level and, as such, will not adequately capture such risks.

In order to ensure a level playing field, we believe that **CCPs should be required to appropriately measure, objectively define and publish the holding periods they use, together with their underlying assumptions for setting these**. CCP assumptions should be based on *actual* trading positions and take into account *actual* stress testing conditions.

4 *At least daily, a CCP should mark participant positions to market and collect variation margin to limit the build-up of current exposures. A CCP should have the authority and operational capacity to make intraday calls for initial and variation margin from participants with positions that have lost significant value.*

The Key Consideration set out above suggests that CCPs should mark participants' positions to market at least daily. In our view, where CCPs have access to real-time positions and prices, they should have the capacity to mark participants to market and to collect initial and variation margin *more frequently* than once a day. The standards should encourage real-time marking of positions and recommend that marking-to-market be conducted *several* times a day.

5 *In calculating margin requirements, a CCP may allow offsets or reductions in required margin across products that it clears or between products that it and another CCP clear, if the price risk of one product is significantly and reliably correlated with the price risk of the other product. Where two or more CCPs are authorised to offer cross-margining, they must have appropriate safeguards and harmonise their overall risk-management programmes.*

We largely concur with the general requirements set out above offsets or margin reductions between products that are cleared at a CCP.

**Cross-margining *between* CCPs introduces risks**. Where two CCPs seek to cross-margin, it is critical that they are able and required to demonstrate that:

(a) their risk and margining procedures are identical
(b) they have harmonised their default management activities, and;
(c) they are able to simultaneously close-out the offsetting contracts that benefit from such cross-margining, consistent with the assumptions made in their margining methodologies.

Explanatory Notes

3.6.4 *This Explanatory Note sets out the Price Information requirements for CCPs.*

The Note indicates that an independent party should validate a CCP's valuation model annually to ensure that the CCP's model accurately reflects market prices. In our view, independent parties will not always be best placed to validate a CCP's pricing algorithms – rather it will be market participants who are best placed to do so. For this reason we would recommend this Explanatory Note is amended to allow for "qualified and independent parties, or market participants".

3.6.9 *This Explanatory Note sets out how CCPs should protect themselves against wrong-way risk, stating that: "a CCP should collect additional initial margin to cover any exposure that could give rise to general wrong-way risk ... In addition, a CCP should identify and mitigate any exposure that may give rise to specific wrong-way risk"*

In our view the Explanatory Note would really need to include a definition of 'specific' and 'general' wrong-way risk to be properly understood. We believe that CCPs should monitor and identify where concentration risks are building up. Furthermore, CCPs should set trigger points based on spreads against benchmark issues along with various market factors, in order to determine where it considers wrong-way risk becomes a material risk. Finally, CCPs should be obliged to closely monitor wrong-way risk and set out clear procedures, with pre-defined trigger points.

3.6.10 *This Explanatory Note sets out how CCPs should address procyclicality in their margin arrangements.*

The Group concurs fully with the statement that CCPs should avoid being procyclical wherever possible, and that margin rates should generally be 'conservative and stable'. However, the 99% coverage level for initial margin set out earlier in this Consultation is inconsistent with 'conservative and stable'.

We do not believe it is the Committees' intention to prevent CCPs from increasing levels of initial margin in times of stress, and agree that it is important that CCPs do not *surprise* their participants with sudden and unpredictable additional margin calls. CCPs must instead be fully transparent in their approach, and have clear rules outlining how they will react in times of stress. These rules should not be purely mechanistic (i.e. they should not *automatically* be triggered by market indicators), but they should provide guidance to supervisors and members, whilst simultaneously allowing for CCP management to exercise discretion. Such an approach will help ensure that CCP actions do not exaggerate market behaviour.

By way of example of how a CCP might actively avoid making sudden procyclical adjustments to margins, the Group has made participants aware of its Sovereign Risk Framework[5] as applied to fixed income margins, under which incremental changes are made to margins as issuer credit deteriorates and further adjustments are possible to cover wrong way risk. As mentioned previously under Principle 5, this approach not only smoothes increases in haircuts, but also follows a publicised framework and makes adjustments according to publicly available market information.

3.6.13 *This Explanatory Note sets out how two CCPs operating a cross-margining arrangement should deal with the default of a participant.*

The Group was surprised to find no mention or consideration of the linked CCPs' default management arrangements or close-out periods. We do not believe that CCPs offering cross-margining must fully harmonise their broader risk management practices, but it is critically important that such CCPs have clear default management arrangements and consistent default approaches that mirror the assumptions within both CCPs' margining methodologies. Furthermore, CCPs should ensure that they have robust legal arrangements for sharing initial margin in the event of a default of a clearing member that is benefitting from cross-margining; both CCPs will rely upon the legal underpinning of the cross-margining arrangements and the certainty of collateral sharing and *in extremis* loss sharing.

If CCPs are able to cross-margin without first establishing an agreed default management approach and simultaneous closeout timing, systemic risk will increase.

3.6.14 *This Explanatory Note sets out how CCPs should test their margin coverage.*

The Group has a number of concerns in respect of this Explanatory Note.

Firstly, we believe that in order to achieve consistency in respect of stress test calculations, CCPs should perform stress tests only on *actual* positions; we do not understand the reference to stress testing on *simulated* positions, and indeed do not believe that CCPs should stress test on simulated positions.

Secondly, the Group is concerned to see that the Committees have set out a *monthly* minimum for back-testing and stress testing; in our view this is far too infrequent. We would urge the Committees to set a daily requirement for back-testing and stress-testing.

Thirdly, we do not believe it is acceptable for CCPs to select individual participants for such tests; instead we believe that CCPs should conduct such tests on *all* participants to which they have exposure.

Finally, we would encourage the Committees to expand the list of stress tests to include the testing of Sovereign risk.

**<u>Principle 7</u>** **<u>Liquidity risk</u>**

***An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources to effect same-day and, where appropriate, intraday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of [one/two] participant[s] and [its/their] affiliates that would generate the largest aggregate liquidity need in extreme but plausible market conditions.***

<u>Key Considerations</u>

2 *An FMI should maintain sufficient liquid resources (that is, liquid assets and prearranged funding arrangements) to effect same-day and, where appropriate, intraday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/two] participant[s] and [its/their] affiliates that would generate the largest aggregate liquidity need in extreme but plausible market conditions. A payment system, CSD, or SSS, including one employing a DNS mechanism, should have sufficient liquid resources to effect, at a minimum, timely completion of daily settlement in the event of the inability of the [one/two] participant[s] and [its/their] affiliates with the largest aggregate payment obligation[s] to settle those obligations. A CCP should have sufficient liquid resources to meet required margin payments and effect the same-day close out or hedging of the [one/two] participant[s] and [its/their] affiliates with the largest potential liquidity need[s] in extreme but plausible market conditions.*

**<u>CCPs must maintain access to sufficient liquid resources to cover the default of their two largest participants (and all such participants' affiliates) under a worst-case scenario</u>.**

Furthermore, CCP liquidity assumptions *must* be consistent with the assumptions governing CCP post-default backing arrangements; as such, there should be a "cover two" requirement for both credit *and* liquidity risk.

<u>Explanatory Notes</u>

3.7.10 *This Explanatory Note sets out the Prearranged Funding arrangements that CCPs must have in place, stating that: "an FMI typically relies on its prearranged funding arrangements that allow the FMI to use its non-cash assets to meet funding needs"; and: "To the extent possible, other funding arrangements should also be committed rather than uncommitted".*

We believe that this Explanatory Note would benefit if it also included clear definitions of "prearranged funding arrangements" and "committed funding arrangements".

3.7.11 *This Explanatory Note deals with* Central Bank services used by CCPs. The Note states that *'with regard to emergency central bank credit an FMI should not assume the availability of such credit as part of its liquidity plan'.*

In the Group's view it is critical that CCPs always have sufficient liquid resources at their disposal with sufficient certainty of their availability. However we see no reason why CCPs that *do* have access to central banks are not able to rely on such facilities as such sources of liquidity.

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**Principle 8 Settlement finality**

***An FMI should provide clear and certain final settlement, at a minimum, by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.***

Explanatory Notes

3.8.3 *This Explanatory Note sets out the processes FMIs should follow for same day settlement.*

The Group agrees in principle that CCPs need to have clear guidelines and requirements that ensure same day settlement. Notwithstanding this, the principle must also take into account extenuating circumstances that CCPs may face, such as the failure of a major settlement bank, or a major systems failure. Furthermore, this Principle ignores the fact that settlement fails can occur and further, could be interpreted to mean that settlement fails are prohibited when in fact settlement fails are beyond the powers of CCPs to avoid. Whilst we are sure this is not the intention of the text, we believe that greater clarity on this point would be beneficial.

**<u>Principle 9</u>** **<u>Money settlements</u>**

***An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.***

CCPs can, and should, monitor and minimise the credit and liquidity risk in respect of money settlements and, equally, should ensure safe and secure settlement – irrespective of whether they use central or commercial bank money. Where the choice is available to CCPs, it should be left to CCPs to choose whether they use commercial or central bank money to effect such settlements. However, given that not all CCPs will have access to central bank settlements (and or will not always be able to effect central bank settlements in all currencies) **<u>it is critical that this Principle does nothing to create an unlevel playing field between CCPs that do have access to central bank settlements, and CCPs that do not.</u>**

**<u>Principle 10</u>** **<u>Physical deliveries</u>**

***An FMI should clearly state its obligations with respect to the delivery of physical instruments or commodities and should identify, monitor, and manage the risks associated with such physical deliveries.***

*<u>Explanatory Notes</u>*

3.10.5 *This Note sets out how CCPs should match participants for delivery and receipt, stating: "An FMI also should have the power to check that its participants have the necessary systems and resources to be able to fulfil their physical delivery obligations."*

Since CCPs do not have "powers" to check such systems and resources, we would respectfully suggest that the wording "power to check" be changed to "monitor performance".

**Principle 13 Participant-default rules and procedures**

***An FMI should have effective and clearly defined rules and procedures to manage a participant default that ensure that the FMI can take timely action to contain losses and liquidity pressures, and continue to meet its obligations.***

The Group supports this Principle as well as the Key Considerations set out in the Consultation document. We would however strongly urge the Committees to add a further Key Consideration to the four listed in the Consultation document, as drafted below.

5. CCPs must have demonstrable risk and default management capabilities and procedures and maintain default management plans.

Explanatory Note

3.13.4 *This Explanatory Note sets out how CCPs should provide for the close out and transfer of a defaulting member's proprietary and customer positions.*

The Group concurs with the provisions set out in the note, however, we would encourage the Committees to include a further consideration in this section, to ensure that CCPs have powers and procedures in place to ensure that - irrespective of the size of any given participant's portfolio - they are still able to manage the resulting close out and/or transfer in the event of the participant's default.

**<u>Principle 14</u>** **<u>Segregation and portability</u>**

***A CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant.***

<u>Explanatory Notes</u>

3.14.5-11 *These Explanatory Notes sets out how the sort of account facilities CCPs should provide for customers.*

Overall the Group concurs with these Explanatory Notes, however, we would recommend that the Notes provide greater clarity on the types of customer referred to, and greater detail on the customer account structures. We also believe it would be helpful if the Notes were more explicit in defining the requirements for different types of customers, and the different approaches for segregation and portability.

We set out some additional commentary in this regard below:

a) The Notes must recognise that CCPs must be able to offer different segregation and portability constructs, depending upon the legal and regulatory requirements under which they operate.

b) The segregation and portability models must, at least, permit CCPs to offer account facilities under the "Complete Legal Segregation" model put forward by the CFTC and as described in the preface to this Annex.

c) The majority of customer collateral is in fact held in omnibus accounts today. In order for a CCP to facilitate the "clear and prompt identification of a customer's collateral" all customer accounts would need to be operationally segregated. The costs and potential operational risks that such structures may introduce mean that CCPs should not be *required* to offer such structures. For this reason we believe the Notes must expressly *permit* CCPs to offer such facilities – but not *require* them to.

**Principle 18   Access and participation requirements**

***An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.***

Explanatory Note

3.18.2 *This Explanatory Note sets out the access requirements for CCPs and other FMIs*

The Group fully supports the "fair and open access" requirements set out by the Committees. Notwithstanding this, we do not believe that CCPs should be required to *encourage* broad access, rather we believe that they should be required to *facilitate* broad access. For this reason we would ask the word "encourage" be replaced with "allow".

**<u>Principle 19</u>** **<u>Tiered participation arrangements</u>**

***An FMI should, to the extent practicable, identify, understand, and manage the risks to it arising from tiered participation arrangements.***

Generally the Group supports this Principle, however we believe that for it to be properly understood more clarification is required in respect of the definition of indirect participants, and whether any differentiation is intended between "indirect participants" and "end-users". We do not see the need for any such differentiation in the case of CCPs.

We would additionally observe that since CCPs do not have direct relationships with, nor full visibility into, indirect participants' exposures, they cannot be responsible for managing the risks arising from such exposures. In our view the monitoring and management of indirect participants' risk concentrations should therefore initially be managed by the introducing participants and, where applicable, by the home-state regulator of the indirect participant itself.

3.19.5 *This Explanatory Note sets out how CCPs must manage the credit and liquidity risks of indirect participants*

CCPs do not have direct relationships with, or visibility into the activities of, indirect participants. As such they cannot be expected to identify which indirect participants may have significant daily turnover, or turnover in excess of that of direct participants.

**<u>Principle 20</u>** **<u>FMI links</u>**

***An FMI that establishes a link with one or more FMIs should identify, monitor, and manage link-related risks.***

<u>Explanatory Notes</u>

3.20.2 *This Explanatory Note sets out how link-related risks must be identified*

As the Committees correctly observe in this Note, cross-margining between two or CCPs introduces a level of risk since the related CCPs will rely on each other's risk-management systems to measure, monitor, and manage credit and liquidity risks. For this reason, we believe that the CCPs must first demonstrate that they have sufficiently robust risk management systems to measure credit and liquidity risks *prior* to any such cross-margining arrangements being implemented. We would therefore encourage the Committees to amend the Note to include such a requirement.

However, in order to have a harmonised policy, linked CCPs should have the ability to call margin from each other at all times. Even if one of the linked CCPs were to go into liquidation, it should not pose a risk of bringing the other down. For this reason, the risk profiles of each CCP should be exactly the same and there should be no differentiation between their risk management approaches.

3.20.14 *This Explanatory Note sets out how CCPs should deal with other risks arising from their link arrangements.*

The Note states that: "typically, CCPs should not contribute to each other's default fund". In our view one CCP should never contribute to the default fund of another CCP, and for such reason we believe that the word 'typically' should be struck out.