ISDA Safe, Efficient Markets

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BY E-MAIL and HAND

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Dear all

Presentation for RBI – Update on global initiatives on CCP recovery and resolution

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful to the Reserve Bank of India (**RBI**) for the opportunity to conduct a presentation on 'Update on global initiatives on CCP recovery and resolution' (**Presentation**) on June 12, 2017 at the RBI office in Mumbai.

As you know, we are in constant dialogue with our members, including global, regional and national financial institutions, end-users and many other financial market participants. The points discussed during the presentation are derived from this experience and our active involvement with regulators and clearinghouses in Asian jurisdictions such as Hong Kong, Singapore, Australia as well as other jurisdictions across the globe such as the United States and the European Union.

We appreciate the opportunity provided to us by the RBI to highlight the concerns of the derivatives market participants with some of the recovery and resolution measures proposed by the Clearing Corporation of India Limited (**CCIL**). These concerns are discussed in detail in the following consultation responses submitted to CCIL:

- *Default Handling-Auction of Trades & Positions of defaulters* submitted on 19 January 2015[2];
- *CCP Recovery and Resolution Mechanism* submitted on 25 September, 2015[3];
- *Proposal to Resize CCIL's 'Skin in the Game' and Restructure Default Waterfall* submitted on 15 December, 2016[4];

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

[2] http://www2.isda.org/attachment/Nzc3Mg==/Submission%20CCIL%20Deafult%20Handling_final.pdf, ISDA, Response to CCIL Consultation Paper: Default Handling-Auction of Trades & Positions of defaulters.

[3] http://www2.isda.org/attachment/ODI2Nw==/India_250915.pdf , ISDA, Response to CCIL Consultation Paper: CCP Recovery and Resolution.

[4] http://www2.isda.org/attachment/OTUxMg==/India%20Submission_121516.pdf , ISDA, Response to Proposal to Resize CCIL's 'Skin in the Game' and Restructure Default Waterfall.

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- *Consultation Paper: Optimizing Segmental Default Fund Contributions* submitted on 31 January, 2017[5];
- *Consultation Paper: Forex Segment- Loss Mutualisation on Settlement Bank Default (USD-INR Segment)* submitted on 31 January, 2017[6]; and
- *Consultation Paper: Recovery tools at the end of the prefunded default waterfall* submitted on 15 March, 2017[7].

We have highlighted these concerns in order to better align CCIL's proposals with the *Principles for Financial Markets Infrastructures* published by the Committee on Payments and Market Infrastructures and the International Organisation of Securities Commissions (**CPMI-IOSCO**), the *CPMI-IOSCO Resilience of Central CCPs: Further Guidance on the PFMI* published in July 2017[8], the *CPMI-IOSCO Recovery of Financial Market Infrastructures* published in July 2017[9], the Financial Stability Board *Guidance on Central Counterparty Resolution and Resolution Planning* published in July 2017[10], and with international best practice seen at market-leading global CCPs.

The main issues that we raised in the meeting are summarized below.

1. **Skin in the Game (SIG)[11]**

   Market participants welcome CCIL's efforts to make the SIG risk-sensitive, however clarity is sought on how shortfalls in SIG will be met. While there is currently no global standard, sizing the SIG to 25% of the clearing member contributed default fund as proposed by CCIL is welcome, and consistent with clearing member expectations for CCP contributions. However, CCIL has not made it unambiguously clear that the SIG will be used for member default losses only. We emphasize that SIG should be dedicated for clearing member default losses only. Separately segregated resources should be earmarked for non-default losses.

2. **Non default losses / Settlement bank failure[12]**

   With regards to the treatment of non-default losses in general, CCIL's resources for non-default losses should be completely separate and segregated from resources allocated for clearing member default losses (i.e., SIG). So that they are properly incentivized to exercise prudent risk management and focus on CCP risk management, CCIL and its shareholders must bear at least some of the risk of all non-default losses and must bear the entire risk of non-default losses that are exclusively within their control (e.g. losses from operational, legal, general business and cyber risks). The CCIL rulebook should unambiguously indicate that default "waterfalls" (including any CCP SIG in the default waterfalls) do not apply to non-default losses as these resources are sized

[5] http://www2.isda.org/attachment/OTUxOA==/India%20Submission_310117.pdf, ISDA, Response to CCIL Consultation Paper: Optimizing Segmental Default Fund Contributions.

[6] http://www2.isda.org/attachment/OTUxNw==/India%20Submission_USD-INR%20Segment_310117.pdf, ISDA, Response to CCIL Consultation Paper: Forex Segment- Loss Mutualisation on Settlement Bank Default (USD-INR Segment).

[7] http://www2.isda.org/attachment/OTUxOQ==/India%20Submission_031517.pdf, ISDA-FIA, Response to CCIL Consultation Paper: Recovery tools at the end of the prefunded default waterfall.

[8] https://www.bis.org/cpmi/publ/d163.pdf, CPMI-IOSCO, Resilience of central counterparties (CCPs): Further guidance on the PFMI - Final report.

[9] https://www.bis.org/cpmi/publ/d162.pdf, CPMI-IOSCO, Recovery of financial market infrastructures - Revised report.

[10] http://www.fsb.org/wp-content/uploads/P050717-1.pdf, FSB, Guidance on Central Counterparty Resolution and Resolution Planning.

[11] Proposal from consultation document "Proposal to Resize CCIL's 'Skin in the Game' and Restructure Default Waterfall" issued on 9 November 2016.

[12] Proposal from consultation document "Consultation Paper: Loss Mutualisation on Settlement Bank Default (USD-INR Segment)" issued on January 2, 2017.

to cover default losses exclusively. It is also crucial to consider and stress-test each potential non-default loss scenario to ensure available funding (e.g., CCIL capital or other funding that would be available with certainty upon the occurrence of the non-default loss). In the event funding is insufficient, CCIL and/or equity holders should bear losses.

With respect to CCIL's proposal for settlement bank failure, market participants are of the view that it is unsuitable to apply a loss mutualisation mechanism to losses not caused by clearing members. Furthermore, we would like to highlight that based on the proposal, clearing members who pre-fund or pay-in early are unjustly penalized. This will result in discouraging pre-funding or paying-in early, exacerbating settlement risk.

3. Reserve price for auction[13]

Market participants are of the view that a robust hedging strategy will reduce market risk and increase probability of a successful first round auction. Furthermore, we would also like to highlight that CCIL should not consider the adequacy of pre-funded default resources as a determinant of the success of an auction. If an auction draws bids for all the auctioned positions, then it needs to be respected, regardless of whether the auction prices lead to a demand for funds that is outside the pre-funded default resources. Assessments called once the prefunded resources are depleted will also be contributed by clearing members. Therefore, the declaration of a reserve price is unwarranted, and increases the propensity of an auction failure in spite of clearing members submitting bids. This increases the likelihood of repeated auctions, while the market might deteriorate even more during this stressed period.

Giving CCIL the ability to override the decision by the Default Management Committee (**DMC)** hinders the effectiveness of the DMC, and the DMC should be given full control of the auction process. Market participants would also like to highlight that there is no incentive for clearing members to collude in an auction, as clearing members are conscious that very low bids will threaten the mutualized default fund and assessments to which they contribute. This serves as a strong disincentive to collude or otherwise "bid badly" in an auction, and we believe clearing members have sufficient incentive to bid sensibly without the need for a reserve price. There are also strongly enforceable laws and penalties for such collusion, which acts as a further disincentive.

4. Cash calls & capped assessments[14]

Allowing multiple cash calls and assessments are highly destabilizing and pro-cyclical. CCIL should be required to size its default fund appropriately, and once this right-sized default fund has been used, the number of total assessments possible should be capped to one times the default fund irrespective of the number of defaults that occur during a defined period, and irrespective of whether resolution commences, to ensure a clear and consistent cap on clearing member liability. CCIL's existing 5 times or higher multiples of unfunded default fund liability is the highest amongst CCPs globally, and should be brought down to one-time assessment of the default fund.

There are also inconsistencies and ambiguities across the different CCIL segments on the maximum contribution of clearing members to replenish the default fund, which means that the actual unfunded default fund liability could be substantially high. In addition, inability to meet the cash calls should constitute a clearing member default which triggers the default management process, and should not directly result in forced allocation of contracts.

[13] Proposal from consultation document "Recovery tools at the end of the prefunded Default Waterfall" issued on 14 February 2017, previously also proposed in "Default Handling-Auction of Trades & Positions of defaulters" issued on 8 December 2014.

[14] Proposal from consultation document "Recovery tools at the end of the prefunded Default Waterfall" issued on 14 February 2017.

Moreover, assessment powers in CCIL's rulebook should apply across recovery and resolution, without differentiation or duplication. Clearing members must be able to calculate at all times the maximum amount that they may be required to contribute under any assessments or cash calls based on the CCIL's rulebook. Introducing additional contingent exposure in resolution statutes would be hugely problematic from a risk-management perspective and would likely be procyclical.

5. Forced Allocation[15]

Market participants are strongly of the view that failure to meet an assessment obligation should constitute a default event which triggers the default management process. Failure of a clearing member to meet its obligations should not directly result in forced allocation, which would be inconsistent with triggering of the default management process. Failure to meet its obligations in the first place is also an indicator that this clearing member might not be in a position to deal with the additional contracts allocated to the clearing member.

In general, the impact on financial stability if clearing members are forced to take on positons that they may not be suited to risk manage in extreme market conditions would always be too great and therefore forced allocation should never be contemplated. If forced allocation is contemplated, it means that an auction or similar mechanism would have already failed and therefore it would have been established that clearing participants are unable or unwilling to clear the problematic positions, for risk management or for other reasons. Any application of forced allocation that tried to address such concerns by allocating positions to those clearing members that "could bear them" would be completely unequitable and therefore should not be allowed.

Contrary to forced allocation, partial tear-ups will return CCIL to a matched book in a way that more evenly distributes risk and exposure across clearing participants and does not require any clearing participants to clear positions that they are not able to risk manage.

6. Partial Tear-Ups (PTUs)[16]

Market participants are of the view that PTUs are an appropriate last resort position allocation tool to re-establish a matched book upon failure of CCIL's auction or similar mechanism to rebalance its book, subject to the following safeguards:

- PTUs should apply to the smallest portion of illiquid contracts possible. Any decisions regarding the scope of contracts to be torn up should be subject to strict governance procedures that are established and disclosed to clearing members on an *ex-ante* basis and account for the views of clearing participants whose positions could be torn up.
- In no event should PTUs take the form of an "invoicing back" that would apply only to those contracts that the defaulting clearing member entered into at inception. Such a scenario would affect only those non-defaulting clearing members that were the original counterparties to the relevant contracts and would therefore mean that such clearing members ultimately remained exposed to bilateral counterparty risk towards another clearing member instead of CCIL.
- Clearing members suffering losses from the use of PTUs must receive claims.

[15] Proposal from consultation document "Recovery tools at the end of the prefunded Default Waterfall" issued on 14 February 2017, previously also proposed in "Default Handling-Auction of Trades & Positions of defaulters" issued on 8 December 2014.

[16] Proposal from consultation document "Recovery tools at the end of the prefunded Default Waterfall" issued on 14 February 2017.

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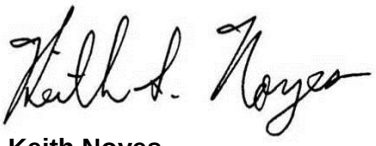
As recovery and resolution discussions are still evolving globally, we would urge RBI to continue an open and constructive dialogue with market participants on aligning these recovery and resolution proposals, as it is imperative that market participants have certainty and clarity on the mechanisms that CCIL is planning to implement.

ISDA thanks the RBI for the opportunity to present the industry's concerns, and we welcome dialogue with the RBI and CCIL on any of the points raised in this presentation. Please do not hesitate to contact me at knoyes@isda.org or at +852 2200 5909 should you wish to discuss any of these issues.

Yours sincerely,

For the **International Swaps and Derivatives Association, Inc.**



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