ISDA Safe, Efficient Markets

17 April, 2015

The International Swaps and Derivatives Association ("**ISDA**"[1]) welcomes this opportunity to comment on several key issues regarding the CCP Recovery and Resolution dossier.

The comments are based on discussions with members of ISDA's Clearing Risk Working Group (**WG**), which comprise representatives from the broad clearing participant community (both sell-side and buy-side).

We focus on the question of whether Initial Margin (**IM**) should be fully protected from haircutting, or whether it should be considered as loss allocation tool. In addition, it asks if there is a situation where IM were to be haircut, whether it should be in recovery or resolution, and whether it would be for the account of the CMs, or all clearing participants.

The purpose of the letter is to address this important issue within the context of a CCP's recovery plans. More specifically, the purpose of this letter is threefold:

1. To state ISDA's strong belief that CCP recovery and continuity (**CCP R&C**)[2] is paramount for systemic stability and clearly preferable to clearing service termination, CCP insolvency or CCP resolution. Towards this objective, ISDA has proposed a CCP recovery and continuity framework which goes beyond the traditional Default Waterfall (**DW**), by including the use of loss allocation and position allocation tools.

2. To communicate ISDA's belief that the possibility of IM haircutting[3] undermines the objective of CCP recovery and continuity as it creates the wrong incentives for clearing participants to run for the exit - away from the CCP - to protect their IM, and in the process competing with the CCP's efforts to match its book. In addition, IM haircutting is not a comprehensive recovery tool (i.e., it may not be sufficiently large to cover losses), and is highly pro-cyclical, as it may bring additional stress to clearing participants at the worst possible time, for the reasons explained further below.

[1] **About ISDA**
Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 67 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, 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 web site: www.isda.org.

[2] See ISDA paper titled "CCP Default Management, Recovery and Continuity: A Proposed recovery Framework", and issued ISDA on January 26, 2015 (http://www2.isda.org/attachment/NzExMw==/Principles%20for%20CCP%20Recovery%20FINAL.pdf).

[3] An ISDA member believes that if client assets must be used, it is more appropriate to pro-rata haircut the total value of client margin including Initial and Variation margin (IM + VM). The member considers haircutting of total equity as more equitable and fair as it defrays the impact on any individual participant.

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3. To highlight the importance of having a clearly defined, ex-ante framework for CCP Recovery and Continuity, by incorporating all the proposed recovery tools in the CCPs' rule books. Clarity and transparency contribute significantly to the need for predictability of outcomes which, in turn, increase certainty and allow clearing participants to quantify their risks and thus design appropriate risk management strategies in periods of market stress.

In the following, we outline ISDA's proposed recovery and continuity framework and ISDA's proposed use of loss allocation and position allocation tools, and the context within which IM haircutting may be contemplated. We highlight why the **PRO**[4] (**P**ro-rata **R**eduction in unpaid **O**bligations) is our preferred loss allocation tool and why partial-tear ups should be considered as a last resort position allocation tool, before a closure of the clearing service/resolution is contemplated. ISDA's preference for PRO is based on the fact that it is a) a comprehensive tool and b) a tool that incentivizes clearing participants to assist the CCP to match its book which has become unmatched by the default of one or more Clearing Members (**CM**s).

1. CCP Recovery and the need for Continuity

With mandatory OTC derivatives clearing, CCPs have emerged as systemically important market participants. Per CPMI-IOSCO PFMIs, CCPs must establish robust recovery and continuity mechanisms to avoid CCP resolution or insolvency. ISDA supports the proposed CPMI-IOSCO measures for promoting CCP recovery and continuity, and to that effect ISDA has proposed a robust and comprehensive framework for CCP R&C. The proposed framework sets out tools that can be used to re-establish a matched book for the CCP, following the default of one or more of the CCP's CMs[5], while at the same time creating the right incentives for clearing participants to assist the CCP in its efforts to restore confidence and viability.

A fundamental component of the ISDA's proposed recovery and continuity framework is the introduction of a loss allocation mechanism in the form of haircutting on a pro-rata basis unpaid obligations, such as Variation Margin (**VM**) gains, named PRO. ISDA's preference for PRO is based on the fact that it is a) a comprehensive tool and b) a tool that incentivizes clearing participants to assist the CCP to match its book which has become unbalanced by one or more CM defaults.

There are two fundamental premises that underpin ISDA's proposed CCP recovery framework:

- CCP viability and continuity is preferable to CCP liquidation, insolvency or resolution as it is less costly, less disruptive and entails less systemic risk.

[4] It should be noted that not all individual ISDA members are in favour of the use of variation margin gains haircutting, or its more general version, PRO (Pro-rate Reduction in unpaid Obligations).

[5] ISDA's proposed recovery framework is aimed to address situations where the CCP is faced with losses caused by the default of one or more CMs (Default Losses – **DL**s). It is not meant to address the situation in which a CCP suffers operational and or investment losses that exceed its allocated capital – the so called Non Default Losses (NDLs).

- Predictability of outcomes increases certainty and enhances the ability of the market place to provide solutions, by properly incentivizing clearing participants and enabling them to quantify their risks and thus design and apply appropriate risk management strategies in advance of and during crisis time.

With these guiding principles in mind ISDA has proposed a recovery framework, tools and processes that are robust, comprehensive and create the right incentives for market participants. ISDA's recommended recovery framework encapsulates the traditional element of the DW, but it goes further by enhancing it and expanding it.

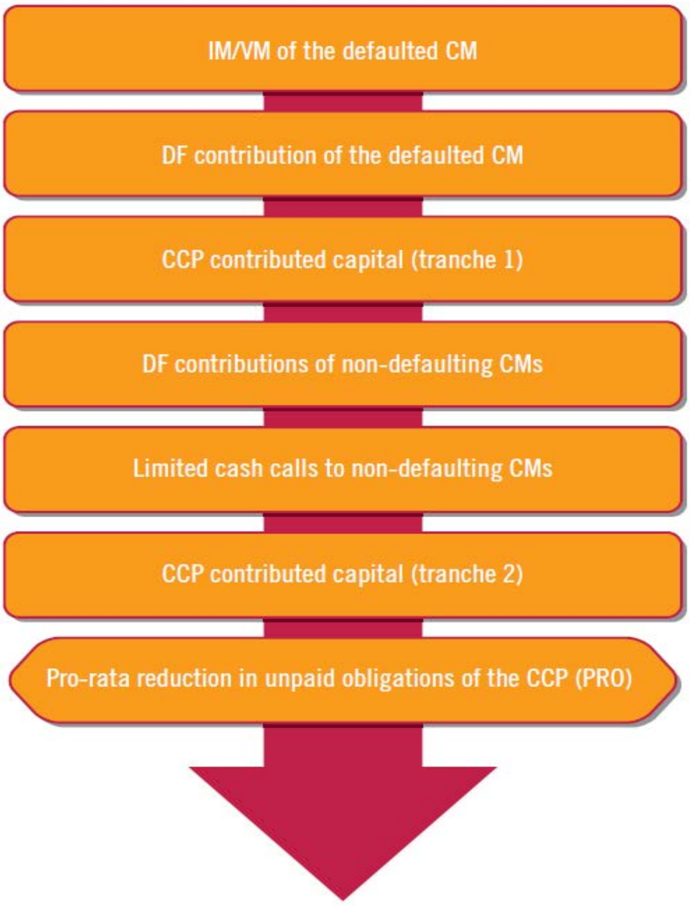
In the event of one or more CM(s)' default, ISDA recommends that CCPs follow their rule books by invoking the Default Management Process (**DMP**). Losses incurred in the process of attempting to establish a matched book should, first, be met by the resources available in the DW. Typically these are: the IM of the defaulting CM, the default fund (**DF**) of the defaulting CM, the Skin-in-the-Game (**SITG**) of the CCP, and the mutualized resources in the form of DF contributions of non-defaulting CMs. If necessary, additional assessments (cash calls) could be imposed on the solvent CMs, provided they are limited and pre-defined, and as such, predictable and possible to manage.

ISDA's proposed recovery framework – captured pictorially in Figure 1 - enhances the traditional DW in several respects. First, in order to properly incentivize strong risk management practices, ISDA calls for CCPs to maintain SITG which should be material so that it is effective. ISDA also offers a strong recommendation as to how SITG should be structured within a CCP's DW. Specifically, ISDA recommends that CCPs should maintain two SITG tranches: one that sits senior to the defaulting CM contributions (which includes IM and contributions to the DF); and a second that is placed senior to mutualized default resources of non-defaulting CMs (non-defaulting CM DF contributions and limited cash calls to such non-defaulting CMs).

In this way, a CCP's own financial resources - first tranche - would be tapped before those of the non-defaulting CMs, thereby serving as an incentive for the CCP to avoid loosening its IM practices, or relaxing its standards for the suitability of a product for clearing. Equally, the CCP's financial resources – second tranche – would be tapped after the funded default resources have been exhausted, thereby serving as incentive to the CCP to avoid loosening the standards (stress tests) used to determine the size of the DF, and align CCP incentives with those of CMs.

ISDA believes these two SITG tranches, properly sized, would encourage CCPs to maintain robust risk management practices, while incentivizing CMs to prudently manage their own risks by not relying excessively on SITG, indicating the need for a SITG that is neither too small nor too large.

Figure 1: Clearing Service Default Waterfall, Including Recovery Measures



Secondly, and crucially, ISDA enhances the existing framework by recommending that CCPs offer segregated clearing services. Such segregation acts as a mitigant against contagion across other clearing services. As such, it is possible for one or more clearing services to fail, while the CCP can contain to operate and offer the remaining clearing services. In addition, a segregated clearing service limits CMs' exposure to losses to those business segments where they are active.

Thirdly, ISDA goes beyond the traditional DW which typically ends once the funded default resources (along with the assessments) are exhausted. It does so, by introducing two new possible recovery tools:

- Loss allocation as a way to expand the pool of default resources, and
- The possibility of position allocation in the form of partial tear-up of positions for which the CCP cannot match at any price from the market

A description of these additional recovery tools follows below.

1.1 Loss Allocation Tools

The use of these tools is recommended if the DMP process is still effective, yet more resources are required for its completion. In ISDA's view, exhaustion of funded defaulted resources is not a criterion for determining whether a clearing service is viable or not. If clearing participants, including both CMs and clients, continue to supply bids in the auction process for the purpose of offsetting unmatched CCP positions, ISDA recommends that loss allocation as a recovery tool should be utilized, as long as its utilization does not increase systemic risk.

The key determinant for making this judgment is based on an assessment that the clearing service is still viable. Such viability is based on the effectiveness of the DMP, that is, as stated above, willingness on the part of market participants to support CCP sponsored auctions and supplying bids to offset unmatched CCP positions in a timely manner without causing contagion.

If a loss-allocation is necessary, ISDA recommends the use of Variation Margin Gain Haircutting (VMGH) or its more general application in the form PRO[6] as the only loss allocation tool that is comprehensive, while creating the right incentives for clearing participants to aid CCP recovery. Specifically,

- PRO is comprehensive as, by definition, in every trade (including derivatives) capital gains are equal to capital losses. As such, in the event that the CCP has been unable to re-establish a matched book, it is not possible for the losses on the portion of the book that remains un-matched to be larger than the gains on the other side of those trades, guaranteeing that almost all such losses can be covered by haircutting the corresponding gains.[7]

- PRO incentivizes non-defaulting clearing participants (both CMs and clients) to reduce their open positions in the CCP. The positions of gain provide the other side of the loss-making positions - held now by the CCP (as the CCP steps in to the defaulted CM(s)' positions). Clearing participants wishing to avoid haircutting of their gains are incentivized (and have a choice) to close such position, thus aiding the recovery process by assisting the CCP to match its book.

In contrast, none of the other alternatives for loss allocation (such as IM haircutting) are comprehensive or create the right incentives for clearing participants. For example, clearing participants wishing to avoid IM haircutting could be impeding the CCP's recovery process by competing with the CCP as they try to close positions, if they have loss positions. Such loss positions are on the same side of those carried by the CCP, competing with it and thus inhibiting the CCP recovery process.

Broadly speaking, loss allocation tools are powerful and if properly chosen and applied could be comprehensive in assisting the CCP recovery, as long as their application does not lead to increased systemic risk. Given the importance of this assessment, ISDA recommends that such determination (as to the use of such tools) is

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[6] See ISDA paper titled "CCP Default Management, Recovery and Continuity: A Proposed recovery Framework", and issued ISDA on January 26, 2015.

[7] See please note that haircutting gains will only cover losses in all circumstances if they are allocated back to the beneficial owner level and not retained at the CM level. If CMs were to retain losses, it would be tantamount to CMs guaranteeing the CCP to their clients

made with consultation with an impartial authority - which, most likely, will be present in these circumstances - and implemented in a limited manner for the time period contemplated by the DMP. In addition, the application of such tools should be made conditional on their not frustrating requisite accounting, legal, risk and regulatory criteria for netting cleared derivatives for accounting and regulatory capital purposes.

1.2 Position Allocation Tools - Partial Tear-ups (termination of contracts)

As noted above, a condition for the use of loss-allocation tools is that the DMP, as exemplified by the auction process, is still effective, i.e., it continues to attract bids at which the CCP can match positions. As long as the auction continues to produce bids (at any price level), loss allocation through PRO can secure the additional resources required for the CCP to match its book and complete the DMP.

However, it is conceivable that the auction may fail to source bids at any price level, for some or all the CCP's open positions. At this point, and before the CCP contemplates closure of the clearing service through a complete (total) contract tear-up, it may be worthwhile for the CCP to consider tearing up the particular set (partial) of contracts which cannot attract any market interest at any price. For example, consider an interest rate swaps (IRS) CCP which may have been successful in attracting bids for 16 out of its 18 different currency denominated IRS books, but has no bids whatsoever for the remaining 2 books. Or alternatively, consider a CDS CCP, where the CCP may have been successful in offsetting all CDS index positions, but not certain single-name CDSs. In such cases, ISDA recommends that CCPs should proceed with offsetting the positions for which auction prices exist, and tear up the remaining positions which cannot be offset at any price (prices cannot be established).

Partial tear-ups should only be considered as a last resort recovery tool for establishing a matched book if the following conditions are present:

- Partial tear-ups cannot be a loss allocation tool.
- Additional time could be helpful in the price discovery process, but balance is required between minimizing losses (by extending the time) and tearing-up contracts as soon as it is practical, to provide clarity and reduce uncertainty. Determination to be made in consultation with an impartial authority.
- The application of such measures does not frustrate requisite accounting, legal, risk and regulatory criteria for netting cleared derivatives for accounting and regulatory capital purposes.

ISDA believes that the potential inclusion of position allocation tools in the form of partial tear-ups as additional recovery tools further enhances the CCP's ability to maintain viability and ensure continuity. Such tools are comprehensive as they can be applied to all troubled contracts. They are also robust as they can work in most envisioned circumstances.

The inclusion of both loss and position allocation tools strengthens significantly the ability of the CCP to recover and restore clearing capability and thus provide continuity of the clearing service. Most importantly, the inclusion of these tools creates the right incentives for clearing participants to aid the clearing service recovery as the threat of having to write off gains due to the termination of contracts that the defaulting CM cannot honour, motivates non-defaulting clearing participants to participate in the auction. By doing so, they maximize the chance of a market based CCP recovery, minimizing the need for external intervention.

Given the asymmetric impact of the recovery tools (both loss and position allocation) on clearing participants, and in order to reduce moral hazard (that is, to avoid the situation in which a CCP reduces its risk management standards, taking into account that clearing participants would bear the losses of the torn contracts), ISDA further recommends that clearing participants affected by the use of such tools should be compensated for losses from the application of such tools by receiving a claim against the CCP's claims against the defaulted CM's estate and from future CCP earnings/revenues. This will ensure a wider and more equitable distribution of losses/costs amongst those benefitting from the continuity (CCP, CMs and clients).

It should be noted that the above loss compensation treatment is consistent with the principle of 'no creditor worse off', as the outcomes produced by the application of these tools would be better than those obtained in insolvency (this is the case if one takes into account the time value of money and other expenses associated with a long lasting insolvency process, e.g. legal costs).

Finally, ISDA recommends that all the proposed recovery tools and the whole recovery framework must be clearly stated in the CCP rule book and reflected in clearing participants' contractual arrangements, in order to be transparent and as such fully predictable to all market participants, allowing them to manage their risk. And because of the contractual agreement between the CCP and its CMs, it should be respected and allowed to run its course, with no supervisory intervention, as long as the DMP remains effective.

2. IM Haircutting in the Recovery Phase as a Loss-Allocation tool

IM is posted by a CM (or client of a CM)[8] for the purpose of covering potential losses (to a degree of certainty) that might be incurred by the CCP in re-establishing a matched book in the event of the default of that specific CM. As such, and under the existing rules of most – if not all - CCPs, and the CPMI-IOSCO PFMIs, IM is not envisaged to be used for the purposes of mutualizing losses that have incurred as a result of the default of a CM/client other than the CM/client who posted the IM.

It has been a long held ISDA view that that the use of IM haircutting as a loss allocation tool should be avoided.[9] There are several reasons why ISDA believes that

[8] By way of background, IM can be posted in various forms – and mainly in the following manner:

- Cash, with title transfer.
- Cash, with some kind of restriction by way of being client money.
- Bonds/securities with title transfer.
- Bonds/securities by way of a pledge (i.e. no title transfer).
- Bonds/securities held by a 3rd party custodian (i.e. no title transfer).

As such, not all posted IM is available to the CCP for its day-to-day purposes. IM that is posted without title transfer is covered by documentation that makes such collateral available to the CCP only in the event of the default of the CM/client that posted the IM.

[9] See ISDA technical paper, CCP loss allocation at the end of the waterfall, which provides further discussion, detail and analysis regarding the utilization and requisite conditions under which PRO could be an effective

IM haircutting is not as effective as alternatives such as VMGH or PRO. The main shortcomings of IM haircutting include the following:

- First and foremost, IM haircutting does not create the right incentives for better risk management and CCP default management - in fact, it incentivizes clearing participants to flatten positions by rushing to the exit (to protect their IM from being haircut), and in the process, competing with the CCP for the hedges the CCP needs to close a defaulting CM's portfolio.

  In fact, the possibility of haircutting undermines the whole recovery process as it dis-incentivizes CMs for participating in the auction process, preferring to put at risk their (smaller by comparison to IM) contributions to the DF, in order to protect their IM (by exiting the CCP).

- Secondly, IM haircutting is not a comprehensive tool. That is, there is no assurance that the amount available in the form of bankruptcy-remote IM, while large, will be sufficient to cover losses incurred in attempting to match the CCP book. PRO, on the other hand, in most scenarios, is expected to achieve this as, in theory, gains equal losses and gains which can be haircut sufficiently to meet such losses.[10]

- Thirdly, the fact that IM – once haircut – would necessitate calls for additional IM (to ensure sufficient IM on non-defaulting CM positions), makes IM haircutting highly pro-cyclical, as such additional calls are likely to come at a period of increased market stress, increasing systemic risk at the worse possible time. Calls for additional IM to cover losses could potentially also lead to unlimited liability scenarios, causing additional stress on participants.

- Finally, the rush to the exit caused by the possibility of IM haircutting, incentivizes clearing participants to stop using the clearing service and/or cleared derivatives altogether (if under clearing mandate) which could lead to further market disruption – something that is contrary to the objectives of CCP and market recovery.

It is on this basis of such considerations that ISDA believes that IM should be protected from haircutting with no exceptions.

2.1 Additional Considerations

IM haircutting application would be exceedingly challenging in the best of circumstances, making it potentially ineffective as a recovery tool, while in the process depriving potentially the CCP from valuable time and resources, by further complicating the DMP process. Specifically:

- Posted Collateral – Bankruptcy Remoteness: One has to take into account the way IM collateral is being posted. Broadly speaking, IM collateral posted with

component of the CCP's recovery framework.
http://www2.isda.org/attachment/NTc5Nw==/CCP_loss_allocation_waterfall_0807.pdf

Also, ISDA paper titled "CCP Default Management, Recovery and Continuity: A Proposed recovery Framework", and issued ISDA on January 26, 2015.

[10] Please note that haircutting gains will only cover losses in all circumstances if they are allocated back to the beneficial owner level and not retained at the CM level. If CMs were to retain losses, it would be tantamount to CMs guaranteeing the CCP to their clients.

bankruptcy remote transfer would not be available for IM haircutting as it is beyond the CCP's reach. As such, one would have to "look-through" the documentation between CCPs, CMs, custodians and clients to ascertain how IM has been posted (see footnote 4). If a look-through approach were to be adopted, regulation would be required to overrule the bankruptcy remote concept in all jurisdictions (both in Europe and outside, including 3rd country CCPs) to ensure a level playing field and the avoidance of regulatory arbitrage opportunities.

- Capital Impact: If the concept of the bankruptcy remoteness is violated, then the impact on the CRR requirements regarding capital weighting for bankruptcy remote collateral would need to be taken into account, as its favorable treatment would come into question, directly affecting (increasing) the cost of clearing and dis-incentivizing clearing.

- Behavioral Changes: If only the collateral posted in non-bankruptcy remote manner would be in scope, consideration should be given to the behavioral changes that would occur in the way IM would be posted. All clients and CMs would be incentivized to post bankruptcy remote collateral leading to two unfortunate side-effects:

  - The absence of cash IM posted with title transfer could have meaningful liquidity implications for the CCP in its day-to-day operations, and
  - There would, in fact, be little to no IM available to haircut due to it all being posted in a bankruptcy remote manner as all CMs and clients would seek to mitigate the haircut risk.

- Implementation Challenges: Another set of questions arises in connection with the IM amount to be haircut. IM changes by the day and, presumably, it will take a number of days - post a CM default - before IM haircutting would be considered. During that time, CM/clients may have continued to clear trades (perhaps deliberately to reduce an open position) which would have caused their IM requirement to change. Even without additional CM/client actions, the nature of IM is such that the IM might change day-to-day irrespective of any change in position.

  If the original IM amount (i.e., the amount as at the time of Default) were to be the amount that is haircut, then CMs would have a reduced incentive to reduce their positions in the CCP as any action on their part could lead to a potential increase the IM amount required. From a systemic risk perspective, this is not a good outcome, acting as a strong dis-incentive for CMs to reduce positions in a CCP that is struggling to manage a default where a reduction in positions would be highly desirable.

3. PRO is a better alternative as a loss allocation tool in the recovery phase

It is worth noting that PRO (VM haircutting) is not subject to any of the above issues:

- PRO is posted in cash with title transfer, so all positions would be covered – and there would be no "arbitrary" split based on how the collateral is posted. As such, there would be no incentive to move such cash into bankruptcy remote structures, with commensurate liquidity benefits (and systemic risk benefits) to CCPs and systemic risk benefits to all market participants.

- Under PRO, the gains cumulated only since the Default date, are haircut (not the gains that occurred before). As such, there is no timing issue.

- PRO does not deplete the IM available to the CCP, thus does not necessitate replenishment of IM, with all the associated un-desirable effects of pro-cyclicality.

- PRO incentivizes the CMs/clients to reduce their open positions in the CCP, thus aiding the recovery process.

- Finally, in the case of derivatives clearing, PRO is comprehensive as, by definition, capital gains are equal to capital losses and in the event that the CCP has been unable to re-establish a matched book, it is not possible for the losses on the portion of the book that remains un-matched to outweigh the gains on the other side of those trades.

4. CCP Losses Due to Non-Default-Losses - NDLs

It is conceivable that a CCP may be stressed due to losses incurred connection with their Investment activities (Losses), or because of non-investment related (operational and other) causes. ISDA is of the view that such losses should be for the account of CCP owners, and CCP equity (along with associated capital requirements) should be used for this purpose. Neither IM haircutting nor any of the loss allocation tools (i.e. PRO) should ever be used for this purpose.

5. Resolution Phase (DLs or NDLs)

Use of IM haircutting is contemplated in the resolution phase as potentially a "bail-able" source of funds to cover losses incurred in the process of establishing a matched book and/or other purposes. The HMT stated: '*The power to haircut IM in resolution is based on the principle that losses should be absorbed by creditors in resolution in a way which is consistent with the creditor hierarchy in insolvency, except where there are strong arguments to depart from that treatment*'.[11]

Because of its belief in the importance of CCP recovery and continuity, ISDA has devoted most of its attention to the CCP recovery framework. An ISDA position on CCP resolution has not been formulated. However, ISDA believes that most of the arguments articulated above, hold for the resolution phase as well.

[11] See, paper by HMT Treasury "UK Response: CCP recovery and resolution: initial margin haircutting".
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ISDA believes that including IM haircutting in the CCP resolution phase, could by itself be destabilizing to the CCP's recovery efforts. Fearful of the possibility of IM haircutting, clearing participants would be highly incentivized to close out their positions (in order to recoup their IM), as soon as the first sign of CCP distress appears (such as CM default), thus damaging the CCP's recovery effort to balance its book and undermining the CCP recovery process.

In addition, the following considerations should be taken into account:

- If a CCP applies PRO for default losses in the recovery phase, it should be able to establish a matched book, as long as the DMP works, making it unnecessary to enter resolution at all, as losses will be allocated in recovery.
- In the case where the CCP enters resolution, for instance because regulators think VM haircutting would be systemically too dangerous, it is likely that *any* way of allocating losses (for instance, IM instead of VM haircutting) would be systemically de-stabilizing.
- It is possible that CCP may need to enter resolution due to a failing DMP (no auction prices can be determined). In this case, loss allocation via PRO would provide similar outcomes to insolvency, and therefore the best implementation of "no creditor worse off".

A CCP where recovery tools have failed - for instance, because the DMP does not work - should be wound down. The product clearly was not clearable in the first place. In that case the question should be raised whether it was a mistake mandating the market to clear this product.

In conclusion, ISDA and the industry supports a robust framework for managing the risks associated with central clearing, and ensuring those risks are borne and managed by those who benefit from the clearing service, in a way that promotes CCP continuity. To that effect, ISDA has put forward a comprehensive and robust framework for recovery. An important component of the proposed framework is loss-allocation, in the event that default resources are exhausted but the DMP is still effective, and PRO is the recommended tool for achieving this objective. IM haircutting is not a realistic alternative to PRO, as it creates the wrong incentives for market participants, undermining the very CCP recovery process.

ISDA would welcome further discussion on the proposed CCP recovery framework and the proposed tools for CCP recovery and their proper use.

Sincerely Yours

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