ISDA Safe, Efficient Markets

24 April 2024

Singapore Exchange Regulation
2 Shenton Way
#02-02, SGX Centre 1
Singapore 068804
(Attention: Regulatory Development and Policy)
By email: rules@sgx.com

Re: Consultation Paper R24-1: Revised Limit on Clearing Members' Liability for Multiple Defaults

Dear Sir/Madam,

The International Swaps and Derivatives Association ("ISDA")[1] appreciates the opportunity to provide comments to SGX RegCo on this consultation paper. We would like to highlight that the scope of the response is limited to only the rules of Singapore Exchange Derivatives Clearing Limited ("SGX-DC").

Executive summary

Our members appreciate SGX's initiative to allow clearing members to cap their liability without resigning for multiple defaults. However, members feel that the methodology for calculating the amount of a non-defaulting clearing member's clearing fund contributions available to meet losses suffered by the SGX-DC arising from or in connection with an event of default is complex and would welcome a simpler framework. To better understand the proposal and calculation method, we would greatly appreciate a call with SGX to clarify our questions as it is imperative that members understand how the proposal affects their liability.

We would like to highlight ISDA's position that assessments / cash calls should be limited to a low multiple of the default fund across recovery and resolution and note that SGX's proposal is far above. While we appreciate that SGX does not use Variation Margin Gains Haircut ("VMGH") and includes its own equity at the end of the default waterfall, we recommend having a reasonable cap over the fixed multiple default period of 90-day to allow greater certainty and time for members to manage their liquidity resources. The cap of 3x Prescribed Contribution is higher than that practiced by most established CCPs and members recommend a lower cap in line with other CCPs i.e., 1-2x of funded default fund. Further, members are of the view that the rolling 30-day cap period would still require members to resign in order to effectively limit their liability. More clarity is needed on how the fixed 90-day Multiple Default Period would apply in combination of the 30-day cap period. Further clarifications on the methodology are included in our response below.

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 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.

Members also feel that the sizing of the current default fund, which is sized to Cover 1 + two financially weakest clearing members seems inadequate and would recommend moving to Cover 2 in line with industry best practices.

Thank you for your consideration of our response and request for a call. Should SGX have any questions on our response, please contact ISDA at speh@isda.org.sg; ukarl@isda.org; and scrowley@isda.org.

ISDA Safe, Efficient Markets

Response to questions

Question (a): SGX seeks views and comments on capping the limit for multiple defaults at three times of a clearing member's clearing fund contribution amount for all defaults occurring within a 30-day period.

- We are supportive for SGX's initiative to enable clearing members to cap their liability without resigning for multiple defaults. However, under the proposed rules, resignation is still the only way for members to effectively cap their liability because the 30-day cap period can keep rolling and members' potential losses and liabilities will continue to increase unless they have resigned. For example, following Scenario 5 under Practice Note 7A.06.9 of Appendix B, assuming a fifth default occurred on day 66 and a sixth default on day 68 and so on, additional liability and loss will be triggered.
- In order to motivate members to stay in the membership, the rules should enable members to predict and cap their potential losses and liabilities at a reasonable amount. Under the proposal, predictability cannot be achieved given the rolling cap period, and 3x of Prescribed Contributions is equivalent to 6x of funded default fund contribution which is more punitive than existing rules i.e., 1x funded contribution per default and 4x funded contribution upon resignation. It is also much higher than the industry recommendation of 1x. For reference, other CCPs that apply a lower cap includes OTC Clear, HKCC and SEOCH (at 2x), KRX at 1x in fixed capped period of 20 trading days (further, KRX does not use VMGH and has its capital at the end of the waterfall for Listed F&O - in line with SGX approach), and JSCC (3x for listed derivatives and 1x for OTC segments). According to ISDA's position, assessments / cash calls should be limited to a low multiple of the default fund across recovery and resolution, and the current proposal is far above.
- Instead of significantly increasing members' maximum clearing fund liability, SGX may consider moving to Cover 2 and enhancing its margin methodology to lessen reliance on unfunded clearing fund contribution from non-defaulting members.
- In addition, it may also consider reducing the liability cap for members and apply a cooling off period, so that the opportunity cost of resigning will become higher.
- SGX may also consider applying a more reasonable cap over the fixed multiple default period of 90-day to allow greater certainty and time for members to manage their liquidity resources.

Question (b): SGX seeks views and comments on the methodology for calculating the amount of a non-defaulting clearing member's clearing fund contributions available to meet losses suffered by the SGX CCPs arising from or in connection with an event of default (as set out in SGX-DC Clearing Rule 7A.06.9.2 and CDP Clearing Rule 7.10.6).

- The calculation methodology is complex as seen in Practice Note 7A.06.9. The examples demonstrate a high level of difficulty clearing members would have to face when estimating their exposure, which may cause error.
- We would like to clarify SGX's rationale for determining the cap amount as at the start of the 30-day period before the first default, instead of the day immediately before the first default. A potential drawback for using the start of the 30-day period is that Clearing Members who have significantly increased their risk positions shortly before the first default may end up contributing less clearing fund resources than those who have maintained lower or stable risk exposures. Determining the cap on the day immediately before the first default will also make it easier for members to manage and calculate their liability.
- Members would welcome a much simpler framework which is more aligned to industry standard for capping their default fund liability. This would essentially mean that the capped period starts with the day of default and assessment multiple is applied to the default fund contributions made on the day of default. This would ensure that clearing members can manage their liability for the next 30 days based on default fund contribution made on Day 1, that is Day of default.
- What are the stress assumptions when determining that 3x of total funded and unfunded clearing fund resources (i.e. Prescribed Contributions) would be necessary to address the default losses? In order to provide for sufficient resources, SGX should consider enhancing its clearing fund sizing methodology from Cover 1+2 financially weakest to at least Cover 2. This will have the benefits of: (i) alignment to the defaulter-pay principle as a larger amount of defaulters' funded contributions will be available in the waterfall structure; and (ii) lowering the cap multiple and reducing the impact of procyclicality for non-defaulting Clearing Members.
- How does the fixed 90-day Multiple Default Period (mentioned under Rule 7A.06.6.1) apply in combination of the 30-day cap period? Rule 7A.06.6.4(d) notes that in case of defaults occurring within the same Multiple Default Period, the use of clearing fund will revert to the start of the sequence. Is there a maximum number of times when the clearing fund sequence can be followed within a 90-day multiple default period? When does the SGX-DC replenish its SITG? May we also understand the rationale behind the 30-day cap period?
- When will the clearing fund replenishment take place for single and multiple defaults respectively? What will be the treatment to any unused balance of Prescribed Contributions?
- Can SGX confirm that in case of single default, the liability of clearing members is capped at 2x of Default Fund (funded plus 1x unfunded Default Fund)?
- What would be liability of resigning members during 30 day notice period during Day 31 to Day 60 (considering member withdraws on Day 31 post default on Day 30 and has to serve Day 30 notice)?

Question (c): SGX seeks views and comments on the rule amendments to effect the proposed change.

Other general comments/clarifications

- SGX's skin-in-the-game at each level of the default waterfall and in aggregate should increase proportionately to encourage clearing members to stay in the membership. Rule 7A.06.8.1 requires the clearing member to replenish its clearing fund deposits prior to the close of business on the business day immediately following the use of the clearing fund deposit. We would like to clarify if SGX-DC also replenishes its SITG as soon as it is used in the waterfall?
- Rule 7A.06.8.2 says that any excess contribution are only applied towards the Clearing Member's own obligations. Can SGX clarify that it means that these contributions are treated as margins or default fund contributions?
- Will there be any differences in the priority or mechanism in the use of Prescribed Contributions from non-defaulting members who are juniorized under the auction mechanism, who have been active in the contract classes in which the default has occurred, and who are not active in the relevant contract classes?