Response to MAS consultation paper on proposed changes to the capital framework for Approved Exchanges and Approved Clearing Houses

Question 1: MAS seeks feedback on the proposed introduction of a separate liquidity requirement.

General comments:

ISDA and FIA (together referred to as "the associations") thank the MAS for the opportunity to respond to the consultation on proposed changes to the capital framework for Approved Exchanges ("AEs") and Approved Clearing Houses ("ACHs"). The scope of our response is limited to the proposed changes to the capital framework for ACHs i.e., central counterparties ("CCPs").

The consultation paper identified various risks that a CCP faces i.e., liquidity risk, solvency risk, operational risk, investment risk and general counterparty risk. Such risks can result in non-default losses ("NDL") which are losses sustained by a CCP as a result of events other than the default of a clearing member.

In July 2020, the associations, published a paper on NDL faced by CCPs ("CCP Non-Default Losses", https://www.isda.org/2020/07/31/ccp-non-default-losses/) expressing our view that CCPs should be responsible for NDL resulting from risks that they manage, such as those mentioned above acknowledging some exceptions where the risks are not within the CCP's sole control. For example, when clearing members select the CCP's custodian, or if the assets remain at the clearing member's custodian but the CCP is granted access to these assets and the custodian defaults or sustained an operational outage. To compare further with financial industry practices, bank custodians do not guarantee against losses from sub-custodians and clearing brokers do not guarantee against losses from custodians to their clients. Hence, CCPs should not be expected to guarantee against losses from custodians to their clients if the custodian selection is decided by the client. Although CCPs should still conduct proper due diligence on its custodians and ensure that custodians selected are supervised and regulated by relevant authorities and have robust internal control frameworks.

For losses stemming from a default or reduction in value of an investment vehicle or counterparty for investment of a clearing participant's cash that has been actively selected by the clearing participant, and where the CCP passes through all the returns from such investments, the clearing participant(s) who directed the investment should bear the losses in full. However, if the investment is decided and managed by the CCP, the CCP should be liable for the losses ensuring the CCP is incentivised to make prudent investment decisions and should be adequately capitalised to cover such losses.

We also responded to the CPMI-IOSCO discussion paper on CCP practices to address NDL in October 2022 highlighting that CCPs should be well capitalized to minimize the risk of resolution and that NDL and CCP capital requirements should be linked, which aligns with the proposal under this MAS consultation paper.

In our response to CPMI-IOSCO, we highlighted that Financial Market Infrastructures ("FMIs") should have a comprehensive register of NDL and have a plan against each item of this register, including estimates of the size of losses, tools and resources to cover for these losses and how to deal with any liquidity gaps. Further guidance standards with respect to the approach that

CCPs should use to quantify the amount of own funds to be held to cover for different NDL scenarios would be helpful in achieving a level playing field between CCPs. You may refer to the response here: https://www.isda.org/2022/10/04/isda-fia-and-iif-respond-to-cpmi-iosco-ndl-discussion-paper/.

Response to question 1:
We are supportive of the introduction of a liquidity requirement that is separate from the solvency requirement as this ensures that the fund required for orderly wind-down or recovery is easily accessible. The size of the liquidity requirement should be sufficient to cover all potential NDLs and combinations of NDLs that the CCP has identified.

We welcome the proposed requirement for "*an AE or ACH to hold cash or near cash assets sufficient to cover at least six months of its operating expenses, or an amount as assessed by the AE or ACH that is needed to achieve recovery or an orderly wind-down, whichever is higher*" as the requirement does not rely solely on six months of operating expenses. Given that the ACH is able to determine the amount required to achieve recovery or an orderly wind-down, the ACH may adjust its assessment such that the former requirement (i.e. minimum of six months operating expenses) becomes the main driver for the sizing of the new liquidity requirement. Therefore, it is worth noting that other jurisdictions require a minimum of 12 months operating expenses (for example, the United States where CFTC Regulation 39.11(a)(2) requires the derivatives clearing organization to cover its operating costs of at least 1 year) and we would welcome the MAS to consider using a more conservative minimum.

The CPMI-IOSCO "Report on current central counterparty practices to address non-default losses" (www.bis.org/cpmi/publ/d217.pdf) flags the importance for CCPs to plan for liquidity gaps in a more detailed fashion than only keeping required funds in cash or near cash (see Section 2.3 Planning for liquidity gaps). For instance, if the plan to address a NDL relies on insurance, the CCP needs also to have a proper plan in place to cover the period from the actual loss until the insurance pays out, which might require additional liquidity provisions.

Question 2: MAS seeks feedback on the proposed changes to the capital components in determining eligible capital.

We agree that only equity instruments should be considered as capital components and any debt or debt-like instruments should not be considered as the use of debt instruments could result in undercapitalizing the CCP and trigger recovery or resolution.

We also agree that a CCP's skin-in-the-game ("SITG") should be excluded from capital components in general as it is dedicated to defined situations like default and non-default events. If a CCP uses its SITG for any NDL, it would have to immediately replenish these funds (although if the CCP is able to do so, it should have used such funds to cover the NDL instead). If the CCP is not able to do so, it would not be compliant with registration requirements. We note that European regulations prescribe to exclude capital contributed in the default waterfall for meeting regulatory requirements[1].

[1] See European Market Infrastructure Regulation, Articles 35, 36 and 45 of the related regulatory technical standards (No 153/2013)

Question 3: MAS seeks feedback on the proposed changes to the operational risk component, investment risk component, and general counterparty risk component of the total risk requirement.

Operational risk component

While we understand that:

1. the operational risk component serves as a proxy to compute capital buffer that can be used to cover interim expenses arising from operational disruptions and
2. the liquidity requirement serves as a pool of liquid assets to provide for ongoing orderly operations of entities to meet obligations on time, or to implement an orderly recovery or wind-down,

we suggest ensuring that these two components align well and do not contradict each other.

For instance, the existing requirement of 6 months of operating expense is a relatively low threshold to capture operational risk. This does not capture any potential settlement losses arising from operational delays and settlement failures, which can both be considered as operational risks, but would also have liquidity risk implications.

As part of assessing operational risk, CCPs should also consider operational disruptions such as system outages, disruptions in systems, and disruption in services provided by vendors appointed by the CCP.

Investment risk component

We would greatly appreciate if MAS could clarify our understanding of the following:

1. We assume that the "8%" weighting used in the current framework is in line with the default number used in other capital regulations.
2. We would welcome some clarity on the rationale behind the 10% risk charge for investments.
3. If the proposed 10% risk charge would be calculated on the notional amount of investments.
4. While it may not be directly relevant to the calculation of investment risk component, would MAS have rules and monitoring mechanism that ensure ACHs only make investments that are in line with their risk mandate and appetite, with sufficient transparency to stakeholders?

General counterparty risk component

We welcome the proposed changes to include all counterparties to be in scope for the calculation of the general counterparty risk component.

We would greatly appreciate if the MAS could clarify the following:

1. While we understand that under the proposed requirements, all counterparties, both members and non-members, will be in-scope of the general counterparty risk component, we would like to clarify if counterparty risk exposures arising from clearing activities will be in scope?
2. We refer to paragraph 5.6(d) of the Draft Notice (i.e. Annex A to the consultation paper), which states that for the purpose of the general counterparty risk requirement, a Specified Person need not include counterparty exposure for cash and non-cash collaterals deposited by clearing members or participants that arise from the Specified

Person's clearing and settlement activities. Could we clarify if this refers to the investment risk associated with the cash and non-cash collateral from clearing members? For instance, SGX invests clearing members' collateral in reverse repo arrangements according to its PFMI disclosure.

3. We refer to paragraph 5.6(e) of the Draft Notice which states that a Specified Person need not include the counterparty exposure for any assets that are accounted for under the investment risk requirement in paragraph 5.3(b). We note that paragraph 5.3(b) refers to 100% of capital investments in subsidiaries and affiliated companies and 10% of the value of any investments involving CCP's own capital. Considering the requirements of this paragraph and that of paragraphs 5.6(a) and 5.6(b), can we clarify what other investment exposures/counterparties will be in scope for the calculation of general counterparty risk?
4. What is the rationale for a lower risk weight (50%) for unrated counterparties than non-investment grade counterparties (100%-150%)? What are considerations and assumptions underlying the risk weights? Will the risk weight be assigned purely based on the credit rating of the counterparty itself, or will the credit rating of the parent entity of the counterparty be taken into consideration?

Ideally, we would welcome more transparency about the composition and distribution of the credit quality profile of the CCPs' counterparties.

Question 4: MAS seeks feedback on the proposed submission and notification requirements.

We support the incorporation of the submission and notification requirements related to an ACH's capital in the regulations but would like to clarify if such information (or a subset of it) will be made public by the CCP or by MAS similarly to Pillar 3 capital disclosure for banks.

We suggest capital-related information (for example, minimum requirement against available balance as well as annual capital plan) to be shared at least with clearing members.

Question 5: MAS seeks feedback on the draft Notice (see Annex A) and draft amended Regulations (see Annex B).

Draft Notice on Capital Requirements for AEs and ACHs

We support the publication of the MAS Notice on Capital Requirement for Approved Exchanges and Approved Clearing Houses as it provides greater clarity and transparency on the capital framework for ACHs. We have set out our feedback on the requirements in our response to Questions 1 to 4.

Proposed Amendments to the Securities and Futures (Clearing Facilities) Regulations

We note that the amendments to the Securities and Futures (Clearing Facilities) Regulations are related to the incorporation of the current requirements to submit and notify MAS on matters related to an ACH's capital, which are set out in an ACH's approval conditions. Please refer to our feedback set out in our response to Question 4.