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BY E-MAIL and HAND

Chief Risk Officer,
Clearing Corporation of India Limited,
CCIL Bhavan, College Lane, off S K Bole Road,
Dadar (West),
Mumbai 400 028

E-mail: rmd@ccilindia.co.in

Cc: Reserve Bank of India (on request from DPSS and FMRD)

Dear Sirs

Consultation Paper: Recovery tools at the end of the prefunded default waterfall

Introduction

The International Swaps and Derivatives Association, Inc. (**ISDA**)¹ and the Futures Industry Association (**FIA**)² (together, the **Associations**) are grateful for the opportunity to respond to the consultation paper on recovery tools at the end of the prefunded default waterfall (**2017 Consultation**) published by The Clearing Corporation of India Limited (**CCIL**) on 14 February 2017.

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

The Associations hope to continue the constructive ongoing dialogue between CCIL and derivatives market participants to assist CCIL in formulating a central counterparty (**CCP**) recovery framework that is at the same time robust as well as in line with international best practices. We note that our members may have feedback which they may wish to provide separately to CCIL.

¹ Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise of 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 web site: www.isda.org.

² FIA is the leading global trade organisation for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's member firms play a critical role in the reduction of systemic risk in global financial markets. Further information is available at www.fia.org.

International Swaps and Derivatives Association, Inc.

Marina Bay Financial Centre Tower 1, Level 11,
8 Marina Boulevard Singapore 018981

P 65 6653 4170

www.isda.org

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Overview

In principle, we welcome the initiative taken by CCIL to develop a set of recovery tools and a well-defined recovery plan, which is consistent with the guidelines for the characteristics of recovery tools under section 3.3.2 of the *Recovery of Financial Markets Infrastructures (Recovery Report)*³ published by the Committee on Payments and Market Infrastructures (CPMI) and the International Organisation of Securities Commissions (IOSCO) (collectively known as CPMI-IOSCO) in October 2014.

We also encourage CCIL to align with section 3.23.2 of the *Principles for Financial Markets Infrastructures (PFMI)*⁴ published by CPMI-IOSCO, which states that “an FMI should adopt clear and comprehensive rules and procedures that are fully disclosed to participants”⁵.

To this end, we strongly urge CCIL to publish a consolidated default management handbook setting out comprehensive details for how a default will be dealt with. This should cover (i) the committee of Clearing Members (CMs) for default handling (referred to as the Default Management Committee (DMC) in the 2017 Consultation); (ii) tranching methodology and hedging requirements for the defaulted portfolio; (iii) the auction process and mechanism to re-establish a matched book; (iv) juniorization (i.e. the extent to which less competitive bidders within the auction process are subject to higher loss attribution); (v) recovery and resolution procedures if a matched book is not re-established; and (vi) fire drills.

Our primary concerns with the 2017 Consultation are outlined below⁶:

- a. Declaration of a reserve price in the auction process (para 3.1.4). Our members are strongly opposed to a reserve price;
- b. Possibility of multiple cash calls and member assessments (para 3.1.5). Additional member liability should be capped to one times the default fund so that members are not exposed to unquantifiable or potentially unmanageable risk;
- c. Requirement for a second round auction only when additional financial resources are contributed (para 3.1.6). A second auction should not be contingent on additional resources from members;
- d. A member failing to respond to a cash call or assessment should constitute a default event which triggers the default management process (para 3.1.7);
- e. Forced allocation should never be contemplated, however partial tear-ups (PTUs) should be used as a last resort position allocation tool to re-establish a matched book (para 3.1.7 and para 3.1.8); and
- f. A member failing to meet margin obligations should constitute a default event which triggers the default management process (para 3.1.8).

We have set out further detail on the specific concerns highlighted above in the **Specific Comments** section of this response on page 7.

General Comments

We wish to set out some overarching comments about what groundwork needs to be done in order to establish effective CCP recovery tools.

Consultation process

In paragraph 3.1.4.1 of the 2017 Consultation, CCIL has indicated that the “*auction model for default handling in derivatives segments was finalized after extensive member consultations and is expected to be formally implemented after the necessary regulatory approvals are in place.*” Our members are concerned

³ <http://www.bis.org/cpmi/publ/d121.pdf>, CPMI-IOSCO, Recovery of Financial Markets Infrastructures.

⁴ <http://www.bis.org/cpmi/publ/d101a.pdf>, CPSS-IOSCO, Principles for Financial Market Infrastructures.

⁵ <http://www.bis.org/cpmi/publ/d101a.pdf>, CPSS-IOSCO, Principles for Financial Market Infrastructures, Paragraph 3.23.2, Page 122.

⁶ For ease of reference, the paragraph numbering reflects that of the 2017 Consultation.

by this statement as we understand there has been no public consultation on the auction process since the “*Consultation Paper: Default Handling-Auction of Trades & Positions of defaulters*” issued on 5 December, 2014⁷ (**2014 Consultation**). ISDA submitted its response to the 2014 Consultation on 19 January, 2015⁸ (**2014 Consultation Response**). From this response, CCIL will be aware of our strong opposition to the reserve price for auctions. CCIL also further requested member views on CCP recovery and resolution in its *Consultation Paper on CCP Recovery and Resolution Mechanism* (**2015 Consultation**) published on 31 July 2015⁹. ISDA submitted its response to the 2015 Consultation on 25 September 2015 (**2015 Consultation Response**)¹⁰. Views expressed in the 2014 and 2015 Consultation Responses are also discussed within this response.

We note the proposed auction structure in the 2017 Consultation is very different from what was originally proposed in the 2014 Consultation. We would appreciate if CCIL can clarify how the proposals outlined in the 2017 Consultation were formulated. We urge CCIL to publish a public response to the 2014 Consultation and the 2017 Consultation to allow the industry to better understand CCIL’s rationale and to give the industry further opportunity to provide their views before CCIL finalizes and implements any proposals.

During the ISDA and CCIL meeting that was held on 6th March 2017, CCIL indicated that the proposed auction structure was approved by CMs after around 4 rounds of working group meetings and a number of member meetings. We understand that not all CMs were informed of these meetings, or of the outcome, and we urge CCIL to make public the minutes of these meetings for the benefit of all CMs.

We also urge CCIL to ensure that all future discussions on these proposals are held in an open and transparent manner, so that all CMs have the same opportunity to respond. We request that any working groups created to discuss these topics are not restricted and are open to all industry participants, and are representative of all CMs.

Global efforts on CCP recovery framework

The Associations have expressed their membership’s views on CCP recovery framework on several occasions. On 25 November 2014, ISDA published a paper entitled *Principles on CCP Recovery* (**2014 ISDA Principles**)¹¹ and on 26 January 2015, ISDA published a paper entitled *CCP Default Management: Recovery and Continuity: A Proposed Recovery Framework* (**2015 ISDA Framework**)¹². In April 2015, FIA published a paper entitled *FIA Global CCP Risk Position Paper* (**FIA CCP Risk Paper**)¹³. On 19 October 2016, the Associations, along with the Global Financial Markets Association (GFMA), the Institute of International Finance (IIF), and the Clearing House (TCH) jointly submitted a response (**CPMI-IOSCO Consultation Response**)¹⁴ to the CPMI-IOSCO consultative report on the *Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI* (**CPMI-IOSCO Consultative Report**)¹⁵. On

⁷https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/12/Consultation_Paper_Default_Handling_Auction_of_Trades_And_Positions_of_Defaulters.pdf, CCIL, Consultation Paper: Default Handling-Auction of Trades & Positions of defaulters.

⁸ http://www2.isda.org/attachment/Nzc3Mg==/Submission%20CCIL%20Default%20Handling_final.pdf, ISDA, Response to CCIL Consultation Paper: Default Handling-Auction of Trades & Positions of defaulters.

⁹[https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/15/Consultation%20Paper_%20CCP%20Recovery%20And%20Resolution_310715\(final\).pdf](https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/15/Consultation%20Paper_%20CCP%20Recovery%20And%20Resolution_310715(final).pdf), CCIL, Consultation Paper: CCP Recovery and Resolution Mechanism.

¹⁰ http://www2.isda.org/attachment/ODI2Nw==/India_250915.pdf, ISDA, Response to CCIL Consultation Paper: CCP Recovery and Resolution Mechanism.

¹¹ <http://www2.isda.org/attachment/NzExMw==/Principles%20for%20CCP%20Recovery%20FINAL.pdf>, ISDA, Principles for CCP Recovery.

¹² <http://www2.isda.org/attachment/NzE5OQ==/CCP%20Default%20Management%20recovery%20and%20continuity%2026-01-2015.pdf>, ISDA, CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework.

¹³ https://fia.org/sites/default/files/content_attachments/FIAGLOBAL_CCP_RISK_POSITION_PAPER.pdf, FIA, FIA Global CCP Risk Position Paper.

¹⁴ [http://www2.isda.org/attachment/ODc5OQ==/FIA-GFMA-IIF-ISDA-TCH%20Response%20to%20CPMI-IOSCO%20Consultative%20Report%20\(Resilience%20and%20Recovery%20of%20CCPs\).pdf](http://www2.isda.org/attachment/ODc5OQ==/FIA-GFMA-IIF-ISDA-TCH%20Response%20to%20CPMI-IOSCO%20Consultative%20Report%20(Resilience%20and%20Recovery%20of%20CCPs).pdf), ISDA, Response to Consultative Report: Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI.

¹⁵ <http://www.bis.org/cpmi/publ/d149.pdf>, CPMI-IOSCO, Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI.

24 October 2016, the industry associations indicated above also jointly submitted a response (**FSB Consultation Response**)¹⁶ on the *Essential Aspects of CCP Resolution Planning (Discussion Note)*¹⁷ published by the Financial Stability Board (**FSB**). The views expressed within this response are in line with those stated in the above ISDA papers, the FIA CCP Risk Paper, and Consultation Responses. We urge CCIL to review these global efforts before finalizing any of the measures proposed in either the 2014 or 2017 Consultation. We would be happy to provide any further information on these global efforts if it is helpful.

Recovery framework

In order to discuss the 2017 Consultation, we submit to CCIL the 2015 ISDA Framework¹⁸, which was guided both by key principles that have been set out by industry participants and by stated regulatory objectives for a comprehensive and effective recovery framework. We would like to highlight that CCIL's proposals in the 2017 Consultation are substantially different from international best practice, and contrary to the guidelines in the Recovery Report which recommends a recovery tool that is comprehensive, effective, transparent, measurable, manageable and controllable, and that creates appropriate incentives and minimizes negative impact.

Effective default management is first predicated on the ability of a CCP to transfer the defaulted CM's positions to solvent CMs in order to re-establish a matched book. The primary tool to re-establish a matched book is a voluntary portfolio auction. This is a tool many leading CCPs have already adopted in their default management processes and one that has worked well under stressed situations, such as the default of Lehman Brothers, to manage the default event as quickly as possible and at the best possible price. If the default management process is unsuccessful in re-establishing a matched book, which is signaled by a failed auction (i.e., an auction in which no bids are received), the CCP may have to consider other means of re-establishing a matched book including, for example, PTUs.

To manage the potential costs throughout the default management process of trying to achieve the objective of a matched book, a CCP should have loss-absorbing resources available that include the defunct CM's pre-funded default resources (its initial margin and its contribution to the default fund), as well as mutualized resources. Such pre-funded resources are organized and consumed in the order of a pre-defined and systemically safe default waterfall which incentivizes sound risk management of the CCP as well as its CMs. CCPs should also consider measures that could provide additional loss-absorbing resources if all pre-funded resources have been exhausted, which should be pre-defined, limited, reasonable and quantifiable.

In this regard, we emphasize that CCP rules should provide for a standard capped liability framework which limits the amount of resources that can be used across single and multiple defaults during the latter of a pre-defined period (being the "cap period") or the end of the default management process. CCPs should be required to size their funded default fund appropriately to ensure they have access to sufficient resources in the event of a member default. Once the default fund has been used, the number of assessments should be capped to one times the default fund irrespective of the number of defaults that occur during the pre-defined period to ensure a clear and consistent cap on member liability. This cap should consistently be

¹⁶ <http://www2.isda.org/attachment/ODqwMw==/FIA-GFMA-IIF-ISDA-TCH-Response-to-FSB-Discussion-Note-CCP-Resolution.pdf>, ISDA Response to FSB Discussion Note: Essential Aspects of CCP Resolution Planning.

¹⁷ <http://www.fsb.org/wp-content/uploads/Essential-Aspects-of-CCP-Resolution-Planning.pdf>, FSB, Discussion Note: Essential Aspects of CCP Resolution Planning.

¹⁸ <http://www2.isda.org/attachment/NzE5OQ==/CCP%20Default%20Management%20recovery%20and%20continuity%2026-01-2015.pdf>, ISDA, CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework.

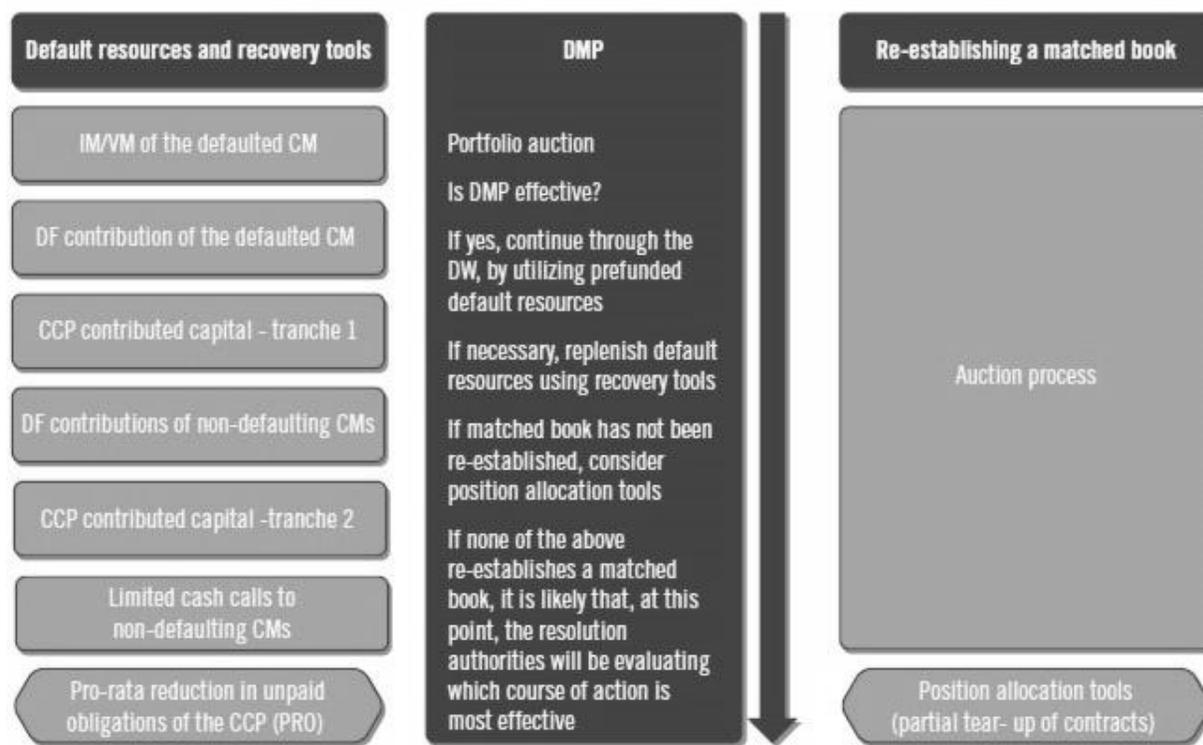
applied for both withdrawing and continuing members to ensure there are no incentives to exit the market, which could potentially cause a run on CCP that could then lead to market instability¹⁹.

Without certainty regarding exposures, clearing as a business becomes problematic because CMs would be deprived of the ability to quantify their risk exposures. Also, multiple assessment calls on non-defaulting CMs at a time of stress could become a significant source of pro-cyclicality with systemic consequences that could threaten the viability of remaining CMs.

If the default management process of a clearing service is unsuccessful in re-establishing a matched book, then the CCP is faced with having to consider the closure of the clearing service (i.e., full contract tear-up, referred to as clearing service termination). However, given the severity of a full contract tear-up, if it remains likely that a CCP could re-establish a matched book for all but a subset of illiquid, highly concentrated and/or outsized positions in the defaulting CMs portfolio(s), a PTU of problematic contracts or a subset of (or product type within) the clearing service would be preferable to full contract tear-up from a systemic and continuity point of view, and should be considered as a last resort position allocation tool in the clearing service rulebook prior to moving to a full contract tear-up.

Table 1 below illustrates the framework discussed above²⁰.

Table 1: Schematic of The Default Waterfall



¹⁹ [http://www2.isda.org/attachment/ODc5OQ==/FIA-GFMA-IIF-ISDA-TCH%20Response%20to%20CPMI-IOSCO%20Consultative%20Report%20\(Resilience%20and%20Recovery%20of%20CCPs\).pdf](http://www2.isda.org/attachment/ODc5OQ==/FIA-GFMA-IIF-ISDA-TCH%20Response%20to%20CPMI-IOSCO%20Consultative%20Report%20(Resilience%20and%20Recovery%20of%20CCPs).pdf), ISDA, Response to Consultative Report: Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI, Page 14.

²⁰ <http://www2.isda.org/attachment/NzE5OQ==/CCP%20Default%20Management%20recovery%20and%20continuity%2026-01-2015.pdf>, ISDA, CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework, Page 9.

Rules regarding resignation and cap

As mentioned above, ensuring that member liability is pre-defined, limited, reasonable and quantifiable is key for CMs to be able to quantify their risk exposures. In this regard, we are concerned with the inconsistencies and ambiguity in CCIL's rules regarding resignation amongst the different clearing segments. For example, the Forex Forward Segment Regulations state that "*Such request for resignation under clause C1 (a) shall be approved by the Managing Director of Clearing Corporation or by an official so authorised by the Managing Director within 2 business days from the Resignation Request Date*"²¹. However, the rules in the Rupee Derivatives Segment Regulations state that "*Such request for resignation under E1 (a) shall be approved **or rejected** by the Managing Director of Clearing Corporation [emphasis added]*"²². There is similar language in place in the regulations for the CBLO Segment²³, Securities Segment²⁴, and Forex Settlement Segment²⁵.

This indicates the potential removal of resignation rights in the Rupee Derivatives, CBLO, Securities, and Forex Settlement segments, which is a key component of liability cap.

In addition, CMs may not be aware of the time required to submit a resignation to trigger the cap. In all segments, the mechanism to cap the liability is for a CM to submit a resignation whenever a loss threshold is reached. However, the rules do not mention very clearly whether CCIL would inform members if the threshold is reached, and it is also unclear if members will be provided with sufficient information to calculate this threshold themselves. There is also general ambiguity around when the 30 day period "immediately after" the loss threshold is reached is triggered (i.e., is it the same day or the next day?), how the loss threshold is computed, and how CCIL recalculates the default fund requirement.

We strongly urge that CCIL resolves this ambiguity around the rules regarding member resignation and cap in liability and addresses the specific points above before finalizing any of the measures recommended in either Consultation. As currently drafted, the lack of transparency may make it impossible for CMs to calculate their exposures.

Financial Resolution and Deposit Insurance Bill

We would also like to highlight the draft Financial Resolution and Deposit Insurance Bill, 2016 (**FRDI Bill**), which is expected to be introduced in Parliament in 2017. Paragraph 45 of the FRDI Bill allows for a Resolution Authority to take additional measures of recovery²⁶. We request that CCIL examines and discusses with the relevant authorities on how the FRDI Bill could possibly interact with the default rules proposed in the 2017 Consultation.

²¹ https://www.ccilindia.com/Membership/ByLawsDocs/FFS%20REGULATIONS_Nov2015.pdf, CCIL, Forex Forward Segment Regulations, Paragraph C2, Page 3.

²² https://www.ccilindia.com/Membership/ByLawsDocs/CCIL_Derivatives%20Regulation_nov.pdf, CCIL, Rupee Derivatives Segment Regulations, Paragraph E2, Page 8.

²³ <https://www.ccilindia.com/Membership/ByLawsDocs/CBLO%20Segment%20Regulations%202016.pdf>, CCIL, CBLO Segment Regulations, Paragraph 5B, Page 5.

²⁴ <https://www.ccilindia.com/Membership/ByLawsDocs/Securities%20Segment%20Regulations.pdf>, CCIL, Securities Segment Regulations, Paragraph E2, Page 7.

²⁵ https://www.ccilindia.com/Membership/ByLawsDocs/Forex%20Segment_Regulations_080916.pdf, CCIL, Forex Settlement Segment Regulations, Paragraph F2, Page 4.

²⁶ <http://finmin.nic.in/fsirc/FRDI%20Bill-27092016.pdf>, Ministry of Finance, Financial Resolution and Deposit Insurance Bill, 2016, paragraph 45, page 49.

Specific Comments

For ease of reference, the headings and paragraph numbers used below correspond to those used in the 2017 Consultation. As highlighted in the 2015 ISDA Framework²⁷, we would like to reiterate that all decisions to use recovery measures beyond pre-funded resources should be based on whether the clearing service is viable.

1. Recovery tools for Forex Forwards and Derivative Segments of CCIL (para 3.1)

i. Auction (first round) with prefunded resources (para 3.1.4)

As indicated in the 2014 Consultation Response, we support and encourage the establishment of an auction process and involving the DMC for all segments of CCIL. However, given that the proposed auction structure in the 2017 Consultation appears to be different from what was communicated in the 2014 Consultation and subsequent discussions, we would appreciate it if CCIL could describe in greater detail as to what the final auction structure being proposed will look like.

As we submitted in the 2014 Consultation Response²⁸, following a default and prior to any auction, CCIL should allow for hedges to be immediately put in place to stem the losses that may arise from the defaulted portfolio from the point of default to the completion of the auction process. While this may not be necessary for all defaults, depending on the size and segment involved, we are of the view that the requirement to hedge should still form part of the default procedures for all segments. The aim of hedging the defaulted portfolio is to eliminate as much market risk as possible that the defaulted portfolio may be exposed to.

We also wish to highlight that any move to an auction process will likely require an increase to CMs margin at risk requirements to account for the possibility of a longer closing out period. As indicated in the 2014 Consultation Response, we suggest CCIL considers increasing the margin at risk requirements to 5 days at a 99.5% minimum confidence level, with a look-back period of 5 to 10 years which is in line with the requirements in Europe. The above changes to the margin methodology should be applicable to both the Forex Forward and Rupee Derivatives segments.

As we have indicated in the 2014 Consultation Response²⁹, we reiterate that our members are strongly opposed to the declaration of a reserve price based on the MTM price of the defaulted portfolio. In line with paragraph 3.3.1.iv³⁰ of the Recovery Report, we strongly believe that CCIL should create appropriate incentives for CMs to participate in the auction. We do not believe that CCIL should set a reserve price for an auction and declare the auction as “failed” if the minimum price is not met. This is a concern because it increases the propensity of an auction failure even though all CMs submitted bids. In a stress situation, any bid should be encouraged and therefore any bids should be accepted. The function of an auction is to set a market driven price for the defaulted portfolio, and we believe CCIL should not mandate a price floor by imposing a reserve price.

The declaration of a reserve price is counterintuitive, and acts as a disincentive to CMs to bid for the defaulter’s portfolio. In addition, as all CMs are conscious that very low bids will threaten the mutualized default fund to which they contribute, we believe this should serve as sufficient incentive for CMs to bid sensibly without the need for a reserve price. The bids submitted by a CM will reflect the risk being brought

²⁷ <http://www2.isda.org/attachment/NzE5OQ==/CCP%20Default%20Management%20recovery%20and%20continuity%2026-01-2015.pdf>, ISDA, CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework, Page 5.

²⁸ 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, Page 2.

²⁹ 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, Page 5.

³⁰ <http://www.bis.org/cpmi/publ/d121.pdf>, CPMI-IOSCO, Recovery of Financial Markets Infrastructures, Paragraph 3.3.1.iv, Page 13.

to its portfolio and will be different for each CM. We understand from previous discussions with CCIL, that CCIL has concerns that CMs would collude to submit off market bids that could force CCIL to absorb losses, and thus CCIL believes that a reserve price is required to protect against this. We strongly disagree with this view because of strongly enforceable laws against such collusion and that CMs have very strong incentives to make the auction work successfully in order to protect their mutualized exposures. There is no credible way to gain from default management, and a standard best practice default management process will incentivize every CM to bid well.

We would also like to highlight that in stressed markets, it will be very unlikely that the MTM from the previous day would also be the price for the auction. The fundamental reason why an auction is needed is precisely because it is difficult to set a price. By setting a reserve price, CCIL will instead increase the likelihood of repeated auctions, while the market might deteriorate even more during this stressed period.

We note that paragraph 3.1.4.7 of the 2017 Consultation states that *“if the MTM loss on the defaulter’s portfolio exceeds prefunded resources, only a portion of the defaulter’s portfolio is likely to get offloaded to winning bidders in this auction. The residual positions of the defaulter will be offloaded through subsequent steps”*. We strongly disagree with the view expressed in this statement. An auction that attracts enough bids to cover the entire CMs portfolio, but does so at a cost exceeding pre-defined default resources, does not constitute a failed auction. The adequacy of pre-defined default resources should not be a determinant of the success of an auction. We emphasize that 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-defined default resources. Recovery measures should be considered as a means of raising these additional funds, as long as the default management process is effective at returning the CCP to a matched book.

If the auction is unsuccessful in attracting bids, which essentially means open positions cannot be auctioned at any price, then the availability of default resources becomes irrelevant, whether they have been exhausted or not. As such, a failure of the default management process is not contingent on whether pre-funded default resources have been exhausted or not: the test is whether the default management process is effective in attracting enough bids, any bids, to cover the open positions³¹.

Finally, we also urge that the DMC be given full control of the auction process. Giving CCIL the ability to override the decision of the DMC hinders the effectiveness of the DMC, and we firmly believe that CCIL should entrust the auction process to the DMC without any caveats and exceptions. As the DMC is usually composed of CMs, they would have the necessary expertise to advise on the auction portfolio. As mentioned above, we strongly urge CCIL to publish a consolidated default management handbook setting out comprehensive details and power of the DMC.

ii. Cash call in proportion to default fund contribution (para 3.1.5)

We would like to reiterate here that CCP rules should provide for a standard capped liability framework which limits the number of assessments³² that can be called during the default management period (or cap period, whichever is the latter) to one times the default fund, and should not require continual replenishment of the default fund.

³¹ <http://www2.isda.org/attachment/NzE5OQ==/CCP%20Default%20Management%20recovery%20and%20continuity%2026-01-2015.pdf>, ISDA, CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework, Page 8-9.

³² For avoidance of doubt, “assessment(s)” refers to an unfunded contribution from each non-defaulting CM equal to the non-defaulting CMs funded contribution to the default fund.

There are inconsistencies and ambiguities across different segments on the maximum contribution of CMs to replenish the default fund. For example, the maximum contribution in the Forex Forward Segment³³ is capped at INR 5500 crore (roughly USD 1 billion), or 5 times the pre-funded contribution, whichever is lower. However, while the Securities Segment³⁴ and Forex Settlement Segment³⁵ specify 5 times the pre-funded contribution, there is no cap specified. The Rupee Derivatives Segment³⁶ and CBLO Segment³⁷, on the other hand, do not specify either a multiple or cap, but instead make reference to a “notified multiple” subject to a notified “monetary ceiling”. This ambiguity means that, in practice, the actual multiple for unfunded default fund liability could be substantially high.

It is also not clear whether “cash calls” in the 2017 Consultation refer to both the requirement to replenish the default fund as well as assessments to CMs. As explained below, requiring multiple replenishment of the default fund as well as calling for assessments is highly problematic. 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 pre-funded default fund.

CCPs are required to size their funded default fund appropriately and should hold sufficient resources in the event of a member default. Once the default fund has been used, the number of assessments that can be called during the default management period (or cap period, whichever is the latter) should be capped at one time the default fund contribution. Assessments that are equal to one times the default fund would at least double the number of member defaults covered. Further cash calls will be destabilizing and likely pro-cyclical.

We also strongly oppose paragraph 3.1.5.1 and 2 of the 2017 Consultation, which states that “members also have the obligation to replenish the default fund” and “non defaulting members who are active in the segment have obligations to meet loss allocation assessment and default fund replenishment together”. We do not believe that CCPs should have the ability to call for default fund replenishments on a continual basis. Requiring CMs to replenish the default fund immediately after its usage would be iterative and entirely inconsistent with caps.

As such, CMs would have no means of determining the number and amount of replenishments that they would have to make over a given period, making it challenging to estimate their liabilities and measure or risk manage their exposure. Continual replenishments can lead to very high default fund liability, potentially conflicting with bank regulatory limits. Continual default fund replenishments are also pro-cyclical and multiple calls increase probability that a CM would fail to pay in the call³⁸. Therefore, CMs should only be required to replenish the default fund after the default management period (or cap period, whichever is the latter).

We would also like to highlight here that it is not clear if the proposals for “cash calls” in the 2017 Consultation are in addition to the pre-existing obligations to replenish the default fund set out in the default fund contribution rules applicable to the different clearing segments, as stated in paragraph 3.1.5.2 of the 2017 Consultation. Also, while the 2017 Consultation states that the cash call amounts from CMs will be in

³³ https://www.ccilindia.com/Membership/ByLawsDocs/FFS%20REGULATIONS_Nov2015.pdf, CCIL, Forex Forward Segment Regulations, Paragraph J(v), Page 26.

³⁴ <https://www.ccilindia.com/Membership/ByLawsDocs/Securities%20Segment%20Regulations.pdf>, CCIL, Securities Segment Regulations, Paragraph J(v), Page 77.

³⁵ https://www.ccilindia.com/Membership/ByLawsDocs/Forex%20Segment_Regulations_080916.pdf, CCIL, Forex Settlement Segment Regulations, Paragraph J(v), Page 44.

³⁶ https://www.ccilindia.com/Membership/ByLawsDocs/CCIL_Derivatives%20Regulation_nov.pdf, CCIL, Rupee Derivatives Segment Regulations, Paragraph J(5), Page 49.

³⁷ <https://www.ccilindia.com/Membership/ByLawsDocs/CBLO%20Segment%20Regulations%202016.pdf>, CCIL, CBLO Segment Regulations, Paragraph J(5), Page 49.

³⁸ [http://www2.isda.org/attachment/ODc5OQ==/FIA-GFMA-IIF-ISDA-TCH%20Response%20to%20CPMI-IOSCO%20Consultative%20Report%20\(Resilience%20and%20Recovery%20of%20CCPs\).pdf](http://www2.isda.org/attachment/ODc5OQ==/FIA-GFMA-IIF-ISDA-TCH%20Response%20to%20CPMI-IOSCO%20Consultative%20Report%20(Resilience%20and%20Recovery%20of%20CCPs).pdf), ISDA, Response to Consultative Report: Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI, Page 14.

proportion to their default fund contributions, in line with paragraph 4.2.10³⁹ of the Recovery Report, it is not clear as to whether there is a cap on the amount that can be called from any member as part of such cash calls.

iii. Auction (second round) with contributed resources (para 3.1.6)

As highlighted above, we do not agree with the proposed framework in the 2017 Consultation which contemplates a second round auction only when additional financial resources are contributed. The adequacy of the pre-defined default resources should not be a determinant of the success of an auction, and all bids, regardless of the price, should be respected. Therefore, as long as the auction is successful in attracting bids, the second round auction should take place immediately after the first round auction, not after CCIL calls for additional resources from CMs. Further, any resulting delay in the second auction would delay the CCP's return to a matched book and could therefore have negative systemic consequences.

iv. Forced allocation of residual positions of the defaulter to non defaulters (para 3.1.7)

As indicated in the 2014 Consultation Response⁴⁰, we reiterate that we do not support CCIL's ability to allocate the positions not taken up by non-defaulting CMs who failed to buy positions up to the minimum level required through the first- and second-round auctions.

Forced allocation of the defaulted portfolio to a CM who may have neither the ability nor the appetite to take on additional positions may further exacerbate the volatility in the market instead of minimizing it. Additionally, the ability of CCIL to set a reserve price, declare an auction as "failed", and force the allocation of positions to non-defaulting CMs may result in the liquidation of the defaulted portfolio at a price that is determined by CCIL, as opposed to a market driven price. Forced allocation may lead to unquantifiable liabilities for CMs, as they would not be able to determine what positions may be allocated back to them and at what price. Such allocation could materially increase the exposure and risk of these CMs vis-à-vis similarly situated CMs that are not allocated positions.

Forced allocation should never be utilized in recovery or resolution, even as a last-resort tool. Forced allocation would never be contemplated until an auction or similar voluntary process had failed. In these circumstances, it would have been established that CMs are unable or unwilling to clear the problematic positions, for risk management or other reasons. Forcing CMs to clear these positions regardless could have adverse consequences on individual CMs, and would almost certainly have adverse systemic consequences.

In addition to financial stability concerns, forced allocation could have an adverse impact on regulatory capital requirements, thereby intensifying pro-cyclical pressure on markets at a time when CMs likely already face capital and liquidity challenges. Therefore, forced allocation should never be contemplated.

Furthermore, paragraph 3.1.7.2 of the 2017 Consultation, which states that "*the residual positions of the defaulter will be forced allocated to the members who did not respond to cash calls*" is highly problematic. If a CM does not respond to a cash call or assessments, this should constitute a member default in itself and should trigger the default management process. As provided in the 2017 Consultation, CCIL is creating an incentive where CMs will intentionally default on cash calls if the commercial or economic considerations of forced allocations are not very negative.

³⁹ <http://www.bis.org/cpmi/publ/d121.pdf>, CPMI-IOSCO, Recovery of Financial Markets Infrastructures, Paragraph 4.2.10, Page 19.

⁴⁰ http://www2.isda.org/attachment/Nzc3Mg==/Submission%20CCIL%20Default%20Handling_final.pdf, ISDA, Response to CCIL Consultation Paper: Default Handling-Auction of Trades & Positions of defaulters, Page 5.

- v. Tear up of all positions of members who failed to honour the margin obligations on account of forced allocations (para 3.1.8)

To start with, as indicated above, if a CM fails to meet the margin obligations it should constitute a default event which triggers the default management process. Failure of a CM to meet its margin obligations should not directly result in tear up of positions. If a CCP fails to return to a matched book upon voluntary auction, but it remains likely that a CCP could re-establish a matched book for all but a subset of illiquid, highly concentrated and/or oversized positions in the defaulting CMs portfolio(s), it may be preferable for the CCP to exercise PTUs. Unlike forced allocations, PTUs return a CCP to a matched book in a way that more evenly distributes risk and exposure across CMs, and does not require any CMs to clear positions where they are not able to effectively manage the risk.

We believe that PTUs should be a last resort position allocation tool to re-establish a matched book upon failure of the CCP's auction or similar mechanism to rebalance its book. We believe that PTUs should apply to the smallest portion of illiquid contracts possible, but recognize that the scope of contracts may need to expand in certain circumstances and may be affected by concerns regarding financial stability. 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 participants on an *ex-ante* basis, and should account for the views of clearing participants whose positions could be torn up.

The price for torn-up contracts should be as close to the fair market value of the contracts as possible so as not to negatively affect accounting or capital treatment for cleared transactions. We note that appropriate pricing may differ across product classes and we have urged the FSB and national regulators to work with CCPs and their clearing participants to establish appropriately consistent procedures and methodologies for pricing torn-up positions⁴¹.

In addition to occurring at fair market value, PTUs should not negate the ability to apply netting (for accounting or capital purposes) or otherwise increase capital, as risks of additional capital charges would dissuade banks from providing clearing services. In general, for netting not to be negated by a partial tear up, the process and methodology for partial tear ups must be clear and documented in the CCP rulebook so that market participants have certainty regarding how their portfolios could be impacted, and how the value at which trades will be terminated will be determined.

Other comments

We note that paragraph 1.3 of the 2017 Consultation states that “*CCIL has created a Settlement Reserve Fund to meet losses from participants’ default and also for losses other than participant default, viz. Settlement bank risk, investment bank risk, custody risk and other operational risks*”. We reiterate the view expressed in our response to the Consultation Paper: *Forex Segment- Loss Mutualisation on Settlement Bank Default USD-INR Segment* (submitted on January 31, 2017)⁴² that CCIL should dedicate a quantum of its resources transparently defined and segregated from its resources for member default losses, and strongly oppose any proposal by CCIL to use the SRF allotted for default losses to meet losses other than participant defaults.

We would also like to take this opportunity to continue dialogue with CCIL on responding to previous ISDA submissions that have been made to CCIL consultations, specifically those below:

⁴¹ <http://www2.isda.org/attachment/ODgwMw==/FIA-GFMA-IIF-ISDA-TCH-Response-to-FSB-Discussion-Note-CCP-Resolution.pdf>, ISDA Response to FSB Discussion Note: Essential Aspects of CCP Resolution Planning, Page 4, 9-10.

⁴² ISDA response is not publicly available as of date.

- Default Handling-Auction of Trades & Positions of defaulters submitted on 19 January 2015⁴³;
- CCP Recovery and Resolution Mechanism⁴⁴ submitted on 25 September, 2015;
- Proposal to Resize CCIL's 'Skin in the Game' and Restructure Default Waterfall⁴⁵ submitted on 15 December, 2016⁴⁶;
- Consultation Paper: Optimizing Segmental Default Fund Contributions submitted on 31 January, 2017⁴⁷; and
- Consultation Paper: Forex Segment- Loss Mutualisation on Settlement Bank Default (USD-INR Segment) submitted on 31 January, 2017⁴⁸.

It is essential to have CCIL respond to these previous consultations, as a comprehensive response to future consultations such as this one are contingent on members having a full and complete understanding of the recovery & resolution mechanism and default handling mechanism that CCIL is looking to implement.

While our members are cognizant of the fact that recovery and resolution discussions are still evolving globally, it would be useful for CCIL to provide an interim response to members about the points raised, in order to continue our constructive dialogue. We believe that this will be mutually beneficial for CCIL and our members.

Conclusion

We would urge CCIL to continue an open and constructive dialogue with members on the auction mechanism, as it is imperative that clearing members have certainty and clarity on the auction mechanism that CCIL is planning to implement. We also urge CCIL to publish a public response to the 2014 Consultation, 2015 Consultation, and the 2017 Consultation, to allow the industry to better understand CCIL's rationale and to respond before CCIL finalizes and implements any proposals.

The Associations thank CCIL for the opportunity to respond to the 2017 Consultation and we welcome dialogue with CCIL on any of the points raised in this response. Please do not hesitate to contact ISDA via Keith Noyes, Regional Director, Asia Pacific (knoyes@isda.org or at +852 2200 5909), Erryan Abdul Samad, Assistant General Counsel (eabdulsamad@isda.org or at +65 6653 4172), Rahul Advani, Assistant Director, Public Policy (radvani@isda.org or at +65 6653 4171), Hyelin Han, Assistant Director, Public Policy (hhan@isda.org or at +852 2200 5903), or FIA via Phuong Trinh, Vice President of Legal & Policy, Asia-Pacific (ptrinh@fia.org or at +65 6549 7335).

⁴³ 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.

⁴⁴ http://www2.isda.org/attachment/ODI2Nw==/India_250915.pdf, ISDA, Response to CCIL Consultation Paper: CCP Recovery and Resolution.

⁴⁵ https://www.ccilindia.com/Documents/whats_new/2016/Consultation_Paper_CCIL's_SIG.pdf

⁴⁶ ISDA response is not publicly available as of date.

⁴⁷ ISDA response is not publicly available as of date.

⁴⁸ ISDA response is not publicly available as of date.

Yours sincerely,

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

Handwritten signature of Keith Noyes in black ink.

Keith Noyes
Regional Director,
Asia-Pacific
ISDA

Handwritten signature of Bill Herder in black ink.

Bill Herder
Head,
Asia-Pacific
FIA