

FMI Feedback
Financial Market Infrastructure Directorate
Bank of England
20 Moorgate
London EC2R 6DA

17 January, 2015

By email: FMIFeedback@bankofengland.co.uk

Dear Madam/Sir,

The International Swaps and Derivatives Association ("**ISDA**"¹) welcomes this opportunity to respond to the consultation paper on the Implementation by the Bank of England (**BoE**) of ESMA's Guidelines and Recommendations on CCP inter-operability arrangements.

Please find below ISDA's response to the questions raised. The response is 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).

Given the increasing importance of CCPs in the functioning of OTC derivatives markets, this response is intended to continue the constructive ongoing dialogue between the BoE and derivatives market participants and to focus on the issues associated with CCP inter-operability. We hope that our comments in this response and follow-up discussions will assist the BoE with the preparation of its guidelines on CCP inter-operability arrangements. In particular, we would like to highlight the following:

1. ISDA is supportive of CCP inter-operability and of the BoE's proposals for the implementation of the ESMA guidelines on CCP inter-operability. Such arrangements are helpful to market participants, particularly in pooling together open order liquidity, and facilitating significant netting efficiencies for Clearing Members (**CMs**), thus promoting the use of clearing.

¹ **About ISDA**

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 66 countries. These members include a broad range of OTC 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 including 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.

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2. We would like to draw your attention under our response to Question 1 to the perspective the WG has taken - that effectively colors the responses to the remainder – calling for a *higher* posted margin (**Linked Margin**), comprised of the stressed margin that is calibrated by using the CCP Default Fund (**DF**) stress scenarios on the inter-connected portfolio.
3. The WG is also of the view that the resources of the non-defaulting CCP - such as its DF and associated waterfall - should be made available, at least in part (and in a sequence/priority to be further discussed/decided), to absorb losses incurred from the failure to pay by the inter-operating distressed CCP, if such losses exceed the Linked Margin. Furthermore, given the potential for contagion risk and to prevent the non-defaulting CCP from entering into Recovery or Resolution, the non-defaulting CCP should prescribe trigger points at which inter-CCP positions will be terminated.

Please note that this response is specifically aimed at addressing inter-operable arrangements between derivatives CCPs, and should not be read to apply to securities settlement CCP inter-operability without further careful consideration. It is also important to stress that the principles and suggestions contained here could be further influenced by developments in the area of CCP Recovery & Resolution (**R&R**). As such, it may be necessary to revisit these positions in the future.

We believe that ISDA's recommendations are aligned and complement the BoE's proposals. As such, we are confident that any gap between the BoE's proposals and ISDA's recommendations does not jeopardize near-term compliance with the ESMA Guidelines. We hope that our recommendations constructively supplement and build on the BoE proposals, and provide the foundation for safer market infrastructures going forward.

Finally, we would like to emphasize the fact that poorly constructed links magnify the cliff-effects inherent within the capital structure of CMs should an inter-operating set of CCPs start to fail, and be deemed non-compliant, per the CPSS-IOSCO PFMIs. This underlines the need for a carefully considered pre-assessment of the compatibility and potential resilience of the link.

ISDA would welcome further discussion on those considerations that should be made in pre-assessing compatibility as opposed to those considerations that lead to the working design of the interoperable link.

Sincerely Yours



George Handjinicolaou
Deputy CEO, ISDA

Responses to the specific questions:

Q1: The Bank would particularly welcome feedback on whether this approach strikes the appropriate balance between safeguarding against the systemic risk of contagion between CCPs and not undermining the benefits of interoperability. The bank would welcome suggestions for alternative methodologies that would also meet the Guidelines. The approach adopted must unambiguously meet the requirement set out in the Guidelines to cover risks with the same degree of rigour as exposures to clearing members.

We agree that CCP inter-operability exposes CCPs to incremental risk of a different nature to that posed by the presence of a single CM and clients thereof. As such, we believe it is important for the inter-operable CCPs to exchange margin. However, our proposed approach contrasts with the BoE suggestion, namely that inter-operating CCPs post to each other a margin that they would “...*ordinarily collect in margin and default fund contribution combined from a CM with the same conditions...*”. We believe that margin between inter-operable CCPs should be the stressed loss calibrated to the same severe but plausible conditions used by the CCP to size the DF.

As stated in the BoE paper, one of the reasons is the fact that CCPs cannot pay into the DFs of their interoperable CCPs. Another reason is that inter-operable CCPs will likely fail only in stressed markets, and posted margin needs to cater precisely for such occasions. ISDA also believes that the CMs of the CCP should have sufficient knowledge of the risk practices (including participation in their risk committees) of the inter-operable CCP, particularly if the link extends to CM mutualization, after the inter-linked posted margin has been exhausted (see our response to Question 3, further down, for more details).

As such, Linked Margin should be higher and, as per our recommendation is **higher** than the collateral a CCP would ordinarily collect in IM and DF contributions from a CM with the same positions (the DF Contribution of a CM in a business-as-usual scenario represents only a portion of un-collateralized stress loss on the two largest CM portfolios).

Such Linked Margin should be met through additional contributions from participants that benefit from inter-operability arrangements. We strongly believe that inter-CCP margin should be set without any mutualized element, so that there are no uncovered losses – which would be the case, if the inter-CCPs positions were to be included in DF sizing. We do not believe that the posting of Linked Margin would be a disincentive to inter-operable arrangements given the expected netting benefits inter-operability arrangements can provide. As such, this does not remove the economic incentive to use a well-founded, consistent and compatible link.

Furthermore, it is not clear that existing CCP risk methods might adequately account for the situation where such a link becomes a source of outsized concentrated exposure. Such a position would be extremely difficult to liquidate, and as such, we suggest that further thought be put into a framework that incentivizes the correct sizing of such Linked Margin, and dis-incentivizes crowded trade positions. One such approach - that may be compatible with wider goals outlined in response to later questions - could be to establish a discrete CCP contribution, or skin-in-the-game, and permit such a contribution (along with the Linked Margin) to not only be available in

the event of “default”, as narrowly defined in EMIR, but to be loss-absorbing under a wider range of failure-to-pay scenarios.²

In considering whether such Linked Margin is sufficient to cover a CCP default, it is important to consider when this margin may be used. As further explained in the response to Q3, such margin should be used if the inter-operating CCP is faced with the default of one or more of its CMs, has exhausted all of its loss-absorbing resources (and other recovery means), and is in default, or in the process of allocating losses in recovery or resolution.

Q2: Do respondents agree that any margin posted by one CCP to another CCP should be separate from and additional to the margins already collected from a CCP’s CMs to cover that CCP’s exposures to its CMs?

We agree with paragraph 12 of the consultation that Linked Margin should not be taken out of the margin pool the inter-operable CCP has collected in the course of its “normal” clearing activities, and it should be *separate and additional* to the margin otherwise collected by the CCPs for two reasons.

- First, inter-operability gives rise to new risks which need to be provisioned for separately and additionally.
- Secondly, if the inter-operable CCP were to use part of its existing margin that it collects in the course of their normal business, this margin would not be available to the CCP to manage a CM default. Fewer resources for default management within one CCP would increase the chance of insolvency of this CCP and thus more likely to increase the likelihood of contagion through the link, if one or more large CMs were to default in stressed markets.

In addition to the above it is important to note the following points:

- Such separate and additional margin should be collected from the CMs using the link and the CCP should have ability to track positions that lead to inter-operability even if it applies portfolio compression
- The CMs contribution to such Linked Margin, should be proportional to their use of the link
- Rudimentary calculations show the posting of such margin incentivizes the use of the link by the participating CMs nevertheless
- Transparency: given that inter-operability gives rise to incremental risk, it is important that CMs of one CCP which are not CMs of the inter-operable CCP should have access to information both regarding the Linked Margin methodology to which they are exposed via the link, and to the risk framework of the linked CCP to the same level as information is shared with the CMs of that linked CCP.

Finally, it is important to note that EMIR Art 53(2) already provides for a prohibition on re-hypothecation of Linked Margin posted under a security financial collateral arrangement. We strongly recommend that regulators go further and put in place

² We would like to clarify the difference between Linked Margin being available to absorb a wider range of losses than those in the event of default, and the concept of IM-haircutting. We believe that there is a structural difference to the nature of consensual provision of resources for the purposes of loss allocation in the context of determining the upfront compatibility of a link, and the desire of a resolution authority to ring-fence all available resources to ensure continuity.

equivalent restrictions for cash or title-transfer arrangements by way of segregation. Further to the BoE's considerations, it would be imprudent for CCP_A post to CCP_B, who in turn posts to CCP_C, who posts Linked Margin under a circular arrangement back to CCP_A. This does not achieve prudential goals, and it is not clear that the EMIR text or ESMA Guidelines go far enough in this regard.

Q3: Should CCPs (i) include exposures to inter-operating CCPs when calculating the loss to their largest two members in extreme but plausible market conditions, and (ii) make the default fund available to meet losses incurred following the default of an inter-operating CCP? Are there other ways in which a CCP can meet the ESMA Guidance to put in place arrangements 'to meet exposures arising from the interoperability arrangement, including in extreme but plausible market conditions'?

If a CCP's contribution to DF is to be included as a resource in the waterfall of resources to absorb losses across from or due to the link, the exposure coming from that link should be included in sizing the CCP DF. However, given that EMIR restricts CCPs from posting DF to each other, we propose that the Linked Margin between inter-operable CCPs should be assessed using the DF stress scenarios, such that the CCP itself will show no uncovered stress loss, which means that DF sizing will not be affected.

With regards to whether the DF should be available to absorb losses resulting from an inter-operable CCP, ISDA is of the view that the DF should be available to absorb such losses.

However, the WG is currently split on how far such access to the DF should go, and in what sequence it should be used. Some members of the WG are of the view that the full CCP DF (and the CCP's capital) should be included in the waterfall of resources to absorb losses across from or due to the link in excess of the Link Margin. As such, for this purpose the CCP DF should be split, and the DF contributions of CMs not using the link should be deemed senior to those that do.

Other members of the WG, on the other hand, are of the view that only the DF contributions of CMs using the link should be included in the waterfall of resources to absorb losses resulting from the link. In either case, DF contributions should only be accessed after the Linked Margin posted by the CCP in distress has been used. To illustrate this point, consider the case of a non-defaulting CCP - say CCP_B - that is being allocated losses from an inter-operating CCP - say CCP_A - which is in recovery or resolution or faces a tear-up of the inter-linked trades (due to linked CCP_A deploying partial tear-up). CCP_B should be able to protect itself from being placed into recovery or resolution by being able to use the Linked Margin posted by linked CCP_A, as soon as there is a failure to pay or tear-up of the inter-linked trades.

Finally, consideration should be given to the potential for contagion risk. In order to prevent the non-defaulting, inter-operating CCP from entering into R&R, ISDA believes that CCPs should prescribe trigger points at which they will terminate their inter-CCP positions.

The above require further discussion as such determinations may also impact the loss allocation on recovery.

Q4: Do respondents agree that it is not desirable or feasible for CCPs to include interoperating CCPs within the scope of their loss-allocation rules? Do respondents have comments on the other measures that interoperating CCPs could put in place to mitigate the impact of the default of an interoperating CCP?

This response is predicated on work that ISDA has done in the context of CCP Recovery³ in which we outline a CCP recovery framework and the tools to be used in allocating losses. This qualification is necessary as not all types of link arrangements and loss-allocation rules can confidently be grouped together under a single response.⁴ It would be desirable that the pre-assessment of compatibility of two CCPs for an inter-operable arrangement makes such considerations explicit, so that participants understand which rules will stand the greatest chance of successfully aiding the marketplace recovery. Such clarity can only be helpful in an environment where we all emphasize the goal of market recovery, not just that of the CCP.⁵

Specifically, for derivative CCPs with developed loss allocation and position rebalancing recovery tools - such as Variation Margin Gains Haircutting (VMGH) and partial tear-up, respectively we believe these tools can be designed to work across the link of two inter-operating CCPs, and should be made to do so. If losses can not be allocated to the inter-operating CCP, then loss allocation or partial tear-up is constrained to the CCP in recovery, and cannot be effected across the link. As such, each CCP's recovery tools are rendered ineffective and non-comprehensive.

We should note that if gains have to be paid across the link no matter what, this may cause CCP insolvency, resolution or full contract tear-up (or service termination), and in each of these scenarios gains may remain unpaid anyway. Similarly, if one CCP cannot re-establish a matched book through voluntary means (i.e., an auction) and losses continue to mount, the CCP must consider a partial tear-up as a recovery tool.⁶ If the CCP cannot also tear up contracts across the link, this tool will not be fully effective and may not be comprehensive with dire consequences.

Thus if CCPs are to inter-operate it is critical that each CCP has developed comprehensive and effective recovery tools, and that each CCP develops rules that can be applied across an inter-operating link.

Using the example in Q3, consider the case of the non-defaulting CCP_B - that is being allocated losses from an inter-operating CCP_A. It should be stated in CCP_B's rule book, that it should be able to protect itself from being placed into recovery or

³ See, ISDA paper titled "*Principles for CCP Recovery*", published in November 2014. Also, please note that there is another ISDA paper forthcoming on CCP Recovery which expands on the concepts outlined in the Principles paper in much more detail.

⁴ The differences between securities and derivatives, between those with Limit Order Books and those without, and considerations of the practicality of recovery tools leading to loss allocation related to Default Losses, or Non-Default Losses, will colour and divide the response to this question.

⁵ Certain approaches can likely be vetoed outright. For example, non-competitive allocation of failed auctions would undoubtedly bring contagion.

⁶ Please see ISDA work referenced in footnote 2.

resolution by using the Linked Margin posted by linked CCP_A, as soon as there is a failure to pay or tear-up of the inter-linked trades. Consideration should also be given to non-defaulting (CCP_B's ability to terminate the inter-linked trades and apply the remaining Linked Margin (if it is close to exhausting the Linked Margin posted to it by CCP_A) or DF contributions of the CMs participating in the link (if it has exhausted the Linked Margin), to enable it to limit its losses and re-balance its own book and CMs. This ties into the discussion on who should bear the losses resulting from linked trades that exceed the Linked Margin at CCP_B in Q3.

Finally, we don't think that porting CMs to an inter-operating CCP is a viable option. Membership criteria may be significantly different across CCPs, preventing in practice the porting of such positions. Equally, documentation cannot be set up quickly enough, and during a default there is no time for the receiving CCP to perform due diligence on these CMs. The only way we can envisage such porting working is if firms have already set-up "back-up" membership arrangements at the receiving CCP.

Q5: Do respondents agree that the risk standards applied to interoperable arrangements for derivatives should be at least as stringent as the standards applied to interoperable arrangements for securities?

Inter-operability poses more challenges for derivatives CCPs because of the higher risk and longer-term exposures associated with derivatives contracts. However, at the same time it provides more transparency to CCPs as to their CMs' exposures, and can enable those exposures to be reduced.

Also, risk management frameworks of derivatives CCPs are more diverse than for equity CCPs - for instance whether intraday margin is called on a regular basis, and how this would flow through the link. The Default Management Processes of the interlinked CCPs may also differ and would have to be brought in line for inter-operable arrangements to work smoothly for derivative CCPs.

As such, we agree that the risk standards applied to inter-operable arrangements for derivatives CCPs should be at least as stringent as the standards applied to inter-operable arrangements for securities.