ISDA® Safe, Efficient Markets

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BY E-MAIL

Dear Sirs,

**Consultation Paper: USDINR Segment – Procedure to be adopted for allocation of funds shortage if shortage exceeds available resources**

1. **Introduction:** The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] welcomes the opportunity to respond to the Consultation Paper on *USDINR Segment – Procedure to be adopted for allocation of funds shortage if shortage exceeds available resources* ("**Consultation Paper**") issued by The Clearing Corporation of India Ltd. ("**CCIL**") on January 9, 2014.

2. **Consultation Paper:** The Consultation Paper proposes to include specific provisions on the shortfall allocation in Indian Rupee ("**INR**") and U.S. Dollars ("**USD**") and a process for shortfall handling. The Consultation Paper also mentions that these proposed provisions and process are intended to facilitate and complete settlement under situations of extreme liquidity stress caused by major defaults, for instance, when multiple participants default at the same time.

   We commend CCIL for taking steps through the proposed provisions and process to strengthen its ability as a central counterparty ("**CCP**") and to ensure completion of settlement as stated in the Principles for financial market infrastructures ("**PFMI principles**")[2] issued by the Committee on Payment and Settlement Systems ("**CPSS**") and the International Organization of Securities Commission ("**IOSCO**"). We would like to provide our comments to certain aspects of the Consultation Paper as set out below.

3. **Chapter VI Defaults:** We refer to the Regulations of the Forex Settlement Segment issued by CCIL ("**Regulations**"), Chapter VI *Defaults* of the Regulations ("**Chapter VI**"), which deals with the default scenarios in which a member fails to deliver and/or pay funds due from it. In particular, we would be grateful if you could please confirm

[1] 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 62 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, clearinghouses 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] http://www.bis.org/publ/cpss101a.pdf, Committee on Payment and Settlement Systems and the International Organization of Securities Commission, Principles for financial market infrastructures, April 2012.

whether the proposed provisions and process as set out in the Consultation Paper are intended to either replace or supplement the existing provisions found in Regulation D *Shortage Handling Procedure* of Chapter VI. Regulation D deals with the default on USD obligation, default on Indian Rupee obligation and loss allocation procedure while the Consultation Paper only addresses the INR shortfall allocation and USD shortfall allocation.

If the proposed provisions are meant to supplement the existing provisions in Chapter VI, these proposed provisions should clearly tie in with the existing Regulations and work with the existing Regulations to provide a clear and concise procedure in the event of defaults. As such, we seek clarity on certain parts of the Regulations and how the proposed provisions in the Consultation will interact with these Regulations.

We note that losses resulting from the shortfall in either USD or INR are borne in accordance with the waterfall as set out in the Regulations. We seek clarification that such losses should first be borne on an indemnity basis by the member who has not paid the relevant currency, such as the payment of interest on late payment of withheld funds which will represent a cost to the clearing house and which should be borne by the member(s) who has caused such shortfall. This is seen in the existing concept found in Regulation (E) *Default Obligations* of Chapter VI.

Regulation (D)(2b) of Chapter VI states that CCIL "shall make good, at the cost of the defaulting Member, the shortfall by availing of a line of credit facility from a credit supporter against Guarantee Fund or borrowing or such other means as the Corporation may deem fit in this respect."[3] In the Consultation Paper, as the second step in the INR shortfall allocation, the proposed provision states that "in the event any member fails to fund its INR account, the lines of credit ("**LOC**") shall be availed by CCIL and the INR shall be completed in all normal circumstances."[4] We seek clarification with regards to the source for the lines of credit in the proposed provision, i.e. whether the LOC will be taken against the Settlement Guarantee Fund ("**SGF**"). If the proposed provision for the LOC is taken against the SGF and this has already been utilized in the default waterfall of the Indian Rupee obligations, as seen in Regulation (D)(h) of Chapter VI, the defaulting member's contribution to the SGF would already have been utilized. We also seek confirmation on the source for seeking the LOC in the event of a USD default. Also, we seek confirmation that the Guarantee Fund in Regulation (D)(2b) of Chapter VI refers to the SGF.

We would also be grateful for your clarification that the loss allocation procedure contemplated under the Consultation Paper is to be applied for the Forex Settlement Segment only and therefore the reference made to members in the Consultation Paper for purposes of the loss allocation procedure is at the segment level only and not at the entity level.

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[3] https://www.ccilindia.com/Membership/ByLawsDocs/CCIL-96-29032007175331.pdf, The Clearing Corporation of India Limited, Regulations (Forex Settlement Segment), Chapter VI(D)(2b), Page 24.

[4] https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/5/Consultation%20paper%20on%20allocation%20of%20shortage%20INR_USD.pdf, The Clearing Corporation of India Limited, Consultation Paper, *USDINR Segment – Procedure to be adopted for allocation of funds shortage if shortage exceeds available resources*, Page 1.

4. **Shortfall allocation:** In the event that the proposed provisions and process are intended to be included in Chapter VI, supplement the provisions in Regulation D and deal with the situations where multiple participants default at the same time, we would be grateful if you could please provide clarification as to how the proposed provisions and process would work together with and complement the existing provisions procedure under Chapter VI.

   For example, we would be grateful if you please clarify whether the SGF contributions of the defaulting members will be used before applying the proposed INR or USD shortfall allocation as proposed in the Consultation Paper. As noted in the Consultation Paper, the proposed INR and USD shortfall allocation should only be utilized in the situation of extreme liquidity stress caused by major defaults. The proposed INR and USD shortfall allocation should only be used as a last resort after all other available resources for settlement have been exhausted. Consequently, we seek further clarity on how CCIL will determine an "extreme liquidity stress caused by major defaults"[5] and the criteria for determining when such a situation has occurred. Greater clarity on the criteria for determining an "extreme liquidity stress" will allow clearing members to project and manage any potential losses that may arise from the INR or USD shortfall allocation.

   The Consultation Paper proposes two options for members who have been allocated the INR shortfall as set out under Option I and Option II on page 2 of the Consultation Paper. Option I provides for an option for CCIL to make a return payment of the equivalent USD amount to members who are allocated a shortfall in INR payments. Under Option II, CCIL will retain the entire USD obligation of the members which were given less INR due to shortfall allocation. While the aim of Option II is to avoid multiple payments between CCIL and its members, it should be noted that this will create an open-ended exposure for the members as they would have no clear timeline as to whether the shortfall will be made good or when the equivalent USD amount returned. We would like to request CCIL to consider including a time limit for Option II to address the concern relating to the open-ended exposure and the associated funding costs members will face as they will still need to fund this USD obligation that has been withheld. In order for both Option I and Option II to be viable options for members, both Options should aim to achieve similar end-result without additional funding costs to CCIL's members.

5. **Allocation to top 10 members:** Paragraph 2A *INR Shortfall Allocation* of the Consultation Paper provides, among others, that if the INR shortfall exceeds the available LOC, the shortfall amount exceeding the LOC shall be apportioned to the top 10 members having INR receivable from CCIL.

   The proposed process for USD shortfall handling is provided for in Paragraph 2B *USD Shortfall Allocation* of the Consultation Paper. If the USD shortfall exceeds the available LOC, the shortfall amount exceeding the LOC shall be apportioned to

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5 https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/5/Consultation%20paper%20on%20allocation%20of%20shortage%20INR_USD.pdf, The Clearing Corporation of India Ltd., Mumbai, Consultation Paper on *USDINR Segment – procedure to be adopted for allocation of funds shortage if shortage exceed available resources*, page 1, 9 Jan 2014.

members having USD receivable from CCIL. It is also proposed that the shortfall shall be allocated to the top 10 members having USD receivable from CCIL.

For both proposed processes for USD shortfall handling and INR shortfall handling, the allocation to the top 10 members would be in proportion to their receivable position from CCIL. Such allocation shall be restricted to maximum 50 percent of their respective receivable amount. However, allocation may exceed 50 percent only if there is unallocated shortfall even after allocation of shortfall to all members having receivable amount in the first phase.

Assuming a situation where there are defaults by multiple participants at the same time occurring over a certain period of time, we seek clarification as to whether there is a limit to the number of times a top 10 member would be apportioned the shortfall amount exceeding the LOC (as described above). We are concerned with the potential unlimited liability a top 10 member may be subject to if there is no limit placed on the number of times a member's receivable amount may be apportioned. Additionally, we seek clarity on the reasoning for allocating the shortfall to the top 10 members instead of all members with a receivable position from CCIL. In an extreme liquidity stress, loss allocation should be assigned to all members of the CCP as all members would be subject to the same stressed market conditions. We are concerned that this proposed rule creates a situation whereby members with loss exposures smaller than the top 10 members are less likely to be required to absorb losses, as these losses are first allocated to members with greater loss positions. If it is less likely that a member is to share in any losses due to its relative size in a particular position, it might be encouraged to take risks disproportionate to its ability to absorb losses, creating an unlevel playing field as compared with the larger participants. It is our view that this proposed structure places the brunt of loss sharing unequally on the larger members. Ideally, loss sharing arrangements must be equitable to all members and provide for a clear cap on liability so that risk can be measured and managed upfront, rather than risk losing the entire settlement amount.

If the aim of the proposal is to ensure the survival of CCIL, the allocation of loss over a larger number of members will ensure the CCP survives for a longer period of time. If the loss is limited to the top 10 members, and these same members are subject to multiple loss allocations, it is possible that some of the top 10 members may then subsequently default, resulting in a worse liquidity situation for the CCP. As the loss allocation is usually the last step in a default management procedure and should occur only under extreme situation, we would like to check if CCIL will institute resolution procedures once it undertakes INR and USD shortfall allocations. As you may be aware, multiple rounds of loss allocations are not sustainable for long periods of time as it is not meant to be a permanent solution.

ISDA appreciates the opportunity to provide comments on the Consultation Paper. If you have any questions on this submission, please contact Keith Noyes at (knoyes@isda.org, at +852 2200 5909) or Cindy Leiw at ( cleiw@isda.org, at +65 6538 3879) or Erryan Abdul Samad (eabdulsamad@isda.org, at +65 6538 3879) at your convenience.

Yours sincerely,

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

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