ISDA® Safe, Efficient Markets

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BY E-MAIL and HAND

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Dear Sirs

Consultation Paper: Loss Mutualisation on Settlement Bank Default (USD-INR Segment)

Introduction

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to respond to the Consultation Paper: Loss Mutualisation on Settlement Bank Default (USD-INR Segment) (**Consultation**) published by The Clearing Corporation of India Limited (**CCIL**) on 2 January 2017.

We 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 Asian jurisdictions such as Hong Kong, Singapore, Australia as well as other jurisdictions across the globe such as the United States and the European Union. We note that our members may have feedback which they may wish to provide separately to CCIL.

General comments

We welcome CCIL's efforts to discuss with members the measures to address settlement bank failures. As you may be aware, with the increased role and importance of central counterparties (**CCPs**) in the financial system in recent years, it is now more than ever critical for CCPs to identify risks associated with their activity, and devise measures that may be utilized to appropriately address those risks. CCPs are subject to a number of risks that could threaten their viability and financial strength, not only limited to default events of its member(s), but also non-default events where losses arise for reasons of business, custody, investment, legal, operational or, as mentioned in the Consultation, settlement bank failure. While measures to address CCP member default losses have been discussed extensively and have been the focus of many policy goals, non-default losses, which are losses that do not result from a default of a member, have not been discussed and examined in detail.

[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.

In October 2014, Committee on Payments and Market Infrastructures (**CPMI**) and the International Organisation of Securities Commissions (**IOSCO**) (**CPMI-IOSCO**) published *Recovery of financial market infrastructures*[2] (**Recovery Report**) which provided guidance on tools to allocate losses not caused by member default. The CPMI-IOSCO further discussed measures to address non-default losses in their consultative report on the *Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI*[3] (**CPMI-IOSCO Consultative Report**) published in August 2016, and the Futures Industry Association (FIA), the Global Financial Markets Association (GFMA), the Institute of International Finance (IIF), the Clearing House (TCH) and ISDA (together, **Associations**) jointly submitted a response to the Consultative Report[4] (**CPMI-IOSCO Response**). In its discussion note on *Essential Aspects of CCP Resolution Planning*[5] (**Discussion Note**), the Financial Stability Board (**FSB**) specifically sought views on resolution planning due to non-default losses. We would also like to draw your attention to the response the Associations jointly submitted on the Discussion Note[6] (**FSB Response**). We note that the CPMI-IOSCO and the FSB are each expected to publish their conclusions to the consultations and final guidelines later this year. We urge CCIL to monitor the progress of the international discussions on non-default losses, and to align with international standards when a set of agreed-upon guidelines are published.

Multiple Settlement Banks

We welcome the proposal to conduct US Dollar settlements through multiple settlement banks simultaneously and to expand the choice of settlement banks available to the members. We agree with CCIL that conducting settlements through multiple settlement banks simultaneously would minimize the exposure on an individual settlement bank, thus reducing the loss that can happen due to settlement bank default. Expanding the choice of settlement banks available to the members would also allow members themselves to better select and manage their settlement banks.

As CCIL has rightly noted, intraday exposures on a settlement bank arise due to the time gap between the final net position report being made available to members and the confirmation of receipt of rupee funds at RBI. We encourage CCIL to further explore ways to reduce this time gap, to reduce the settlement bank risk faced by CCIL.

Insurance Cover

As the Recovery Report also states, insurance may be an effective way of addressing the impact of losses not caused by member default. Some of our members are supportive of considering insurance coverage for settlement bank failure, even if the burden of sharing the cost of insurance falls to the members, as long as it is at a reasonable level. Some members agree with the Recovery Report that the timeliness and reliability of such arrangements would be subject to a number of factors including the lead time required for having a claim processed and paid, not to mention that such claims might be challenged by the insurance provider, which would hinder the effectiveness of such arrangement at times of settlement bank failure. These factors that affect the efficacy of insurance coverage and the share of cost to be borne by members would need to be discussed in further detail. We urge CCIL to hold a separate consultation discussing the specifics of insurance coverage with members.

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[2] http://www.bis.org/cpmi/publ/d121.pdf
[3] http://www.bis.org/cpmi/publ/d149.pdf
[4] http://www2.isda.org/attachment/ODc5OQ==/FIA-GFMA-IIF-ISDA-TCH%20Response%20to%20CPMI-IOSCO%20Consultative%20Report%20(Resilience%20and%20Recovery%20of%20CCPs).pdf
[5] http://www.fsb.org/wp-content/uploads/Essential-Aspects-of-CCP-Resolution-Planning.pdf
[6] http://www2.isda.org/attachment/ODgwMw==/FIA-GFMA-IIF-ISDA-TCH-Response-to-FSB-Discussion-Note-CCP-Resolution.pdf

Liquidity Coverage

Also, in times of settlement bank failure, liquidity shortfalls may arise in addition to losses. To cover liquidity shortages, we encourage CCIL to consider mechanisms such as liquidity facilities that could be arranged on an *ex ante* basis and available in a timely manner. ISDA members believe that liquidity facilities from central banks would be the most reliable in a time of distress but also support private-sector provided liquidity facilities.

Allocation of CCIL's resources to absorb losses from Settlement Bank failure

We commend CCIL's proposal to dedicate a portion of its financial resources to a settlement bank failure. This is in line with the guidance of the Recovery Report which prescribes that a CCP needs to have sufficient capital, and a viable plan to recapitalise in circumstances where the CCP's capital is used, to absorb losses arising from participants' funds held at payment or settlement banks[7]. We reiterate the view made on previous occasions[8] that members should not be responsible for covering any non-default losses incurred by a CCP, as they should not be held liable for the risks they cannot manage. We believe that CCPs, their parents and their ultimate equity holders should account for all non-default losses and therefore should hold resources to do so, transparently defined and segregated from its resources allocated for member default losses.

In this regard, we strongly oppose CCIL's resources for absorption of losses from settlement banks failures to be used in the scheme of loss mutualisation among members ("CCIL Skin in the game"). For reasons stated in the below section, we strongly oppose member loss mutualisation framework to be applied for settlement bank failures. We strongly believe that CCIL's quantum of resources should be clearly quantified to account for all losses from settlement bank failures, and segregated from its resources allocated and framework utilized for member default losses.

Therefore, we would like to seek clarification from CCIL how it would fund the proposed portion of the Settlement Reserve Fund (**SRF**) for absorption of the losses due to settlement bank failure. The Consultation states that approximately Rs 50 crores from the SRF is being proposed for settlement bank failure in USD-INR segment. It is noted that this amount is approximately the amount of adjusted skin-in-the-game proposed at 25% of member contributed default fund[9]. Appropriating the same SRF resources for both default and non-default situations would undermine the quantum of resources available for both. Even in situations where a member that is also a settlement bank for the CCP defaults that the CCP suffers both a default loss and a non-default loss, the portion of the losses that are attributable as non-default losses should not be treated the same as default losses and should therefore be covered by separately designated resources. We commend CCIL for allocating its funds to cover potential losses from a settlement bank failure, but we strongly urge CCIL to hold a separate quantum of resources available for losses due to settlement bank failure that is transparently defined and segregated from its resources dedicated to member default losses.

[7] See paragraph 4.6.1 and 4.6.2 of the Recovery Report
[8] See CPMI-IOSCO Response and FSB Response
[9] Proposal to Resize CCIL's 'Skin in the Game' and Restructure Default Waterfall published on 9 November 2016

Loss Mutualisation

We strongly oppose CCIL's proposal to allocate losses due to a settlement bank failure to the members that settle through the same bank. Members should not be held liable for the default of a settlement bank, as failure of a settlement bank is not a risk that members can manage. Any attempt for CCIL to make members directly responsible for non-default losses creates a moral hazard for CCIL as it will no longer be incentivized to best manage and monitor the non-default risks.

The unique loss mutualisation arrangements present in CCPs, so that losses due to member default are largely borne by the members, are because CCPs concentrate the credit and counterparty risk that members bring to and manage at the CCPs. The default risk that exists between market participants is replaced by the risk to a single counterparty, the CCP. This counterparty risk that exists in normal market activities is then mitigated by ensuring that enough resources are held at the CCP and that the rules governing the member default event are suitably robust. The loss mutualisation mechanism to address default losses therefore is designed under the principles of "defaulter pays", appropriate level of CCP skin-in-the-game in the default waterfall and loss allocation proportionate to the risk that the members bring to the CCPs – the size of their trade exposure. Therefore, it is unsuitable to apply the loss mutualisation mechanism to losses not caused by members.

Moreover, according to the methodology illustrated in the scenarios included on the Consultation, members who pre-fund or pay-in early their settlement are unjustly penalized. This would discourage members from pre-funding or paying-in early their settlement obligations which would exacerbate settlement risk, the direct opposite of the desired outcome. Also, allocating losses to members who pre-fund or early pay-in their settlement obligation regardless of their net obligation is inequitable and disproportionate to their trade exposure, and is therefore very problematic.

Other comments

We welcome further dialogue with CCIL on the points raised above, and would be grateful for the opportunity to engage with CCIL on any specific clarification that may be required.

In addition, ISDA would like to take this opportunity to engage with CCIL for responses to previous submissions that have been made to CCIL consultations, specifically on those below:

- CCP Recovery and Resolution Mechanism submitted on September 25, 2015[10],
- Default Handling: Auction of Trades & Positions of Defaulter submitted on January 19, 2015[11], and
- Proposal to Resize CCIL's 'Skin in the Game' and Restructure Default Waterfall[12] submitted on December 15, 2016.

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 & 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 constructive dialogue.

[10] http://www2.isda.org/attachment/ODI2Nw==/India_250915.pdf
[11] http://www2.isda.org/attachment/Nzc3Mg==/Submission%20CCIL%20Deafult%20Handling_final.pdf
[12] https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/19/Consultation_Paper_CCILs_SIG.pdf

ISDA

ISDA thanks the CCIL for the opportunity to respond to the Consultation and welcomes dialogue with CCIL on any of the points raised, as well as any other areas. Please do not hesitate to contact 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), or Hyelin Han, Assistant Director, Public Policy (hhan@isda.org or at +852 2200 5903).

Yours sincerely,

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