ISDA. Safe, Efficient Markets

**31 January 2017**

**BY E-MAIL and HAND**

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Dear Sirs

**Consultation Paper: Optimizing Segmental Default Fund Contributions**

*Introduction*

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to respond to the consultation paper on Optimizing Segmental Default Fund Contributions (**Consultation**) published on 6 January, 2017.

In principle, we welcome the initiative taken by The Clearing Corporation of India Limited (**CCIL**) to create a structure where default fund shortfalls are covered by CCIL immediately, to the extent possible, by optimizing the movement of collateral from clearing members to CCIL for meeting their default fund obligations. We believe that such a structure will also help in streamlining operations and reducing operational overheads for clearing members, and will be consistent with the requirement to promptly replenish prefunded resources under the *Principles for Financial Markets Infrastructures* (**PFMI**)[2] published by the Committee on Payments and Market Infrastructures (**CPMI**) and the International Organisation of Securities Commissions (**IOSCO**) (**CPMI-IOSCO**).

As you know, 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.

ISDA hopes to continue the constructive ongoing dialogue between CCIL and derivatives market participants to consider, for example, the practical concerns and risks surrounding the implementation of the measures outlined in the Consultation. 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, Today, ISDA has over 850 member institutions from 67 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] http://www.bis.org/cpmi/publ/d101a.pdf

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*General Comments*

In principle, our members are broadly supportive of the measures proposed in the Consultation to optimize the allocation of collateral between the default funds of some segments, subject to the clarifications and caveats outlined in the Specific Comments section below. These clarifications are sought in order to better align the Proposal with the PFMI published by CPMI-IOSCO, as well as the *Principles for CCP Recovery* (**ISDA Principles**) published by ISDA[3]. We would also like to draw your attention to the draft guidance provided in the CPMI-IOSCO consultative report on the *Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI (***Consultative Report***)* published in August 2016, and the response jointly submitted by the Futures Industry Association (FIA), the Global Financial Markets Association (GFMA), the Institute of International Finance (IIF), the Clearing House (TCH) and ISDA[4].

However, based on the PFMI, ISDA Principles, and Consultative Report, we would like to highlight that our members are concerned with the measures proposed in the Consultation with respect to the funding of a shortfall in the default fund from a surplus balance in the Securities Segment Settlement Guarantee Fund (**SGF**) and unencumbered CBLO collateral for the default fund of the CBLO segment. The reasons and rationale are outlined in the Specific Comments section below.

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

- CCP Recovery and Resolution Mechanism[5] submitted on September 25, 2015; and
- Default Handling: Auction of Trades & Positions of Defaulter[6] submitted on January 19, 2015.
- Proposal to Resize CCIL's 'Skin in the Game' and Restructure Default Waterfall[7] submitted on December 15, 2016[8].

As highlighted in the Other Comments section, 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.

*Specific Comments*

*Meeting the deficit in default fund for a segment from surplus balance in default fund in another segment*

With reference to section 3.1 of the Consultation, our members are supportive of CCIL taking steps to optimize the allocation of collateral between the default funds of the Forex Forwards, Rupee Derivatives, Forex Settlement, and Securities segments only. However, this is contingent on CCIL providing clearing members with detailed information on how the process will work in practise, as well as providing clearing members with detailed information as to how collateral has been allocated to the various default funds. We request that CCIL provide members with this information prior to operationalising such an optimisation process.

Our members would also like to seek confirmation that this process will not be carried out on a mutualized basis, i.e., the surplus in a default fund of one clearing member will only be used to offset the shortfall in another default fund of the same clearing member, and not other clearing members. Our members would also request CCIL to confirm if this is intended to be a mandatory process, or if members will be able to

[3] http://www2.isda.org/attachment/NzExMw==/Principles%20for%20CCP%20Recovery%20FINAL.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://www2.isda.org/attachment/ODI2Nw==/India_250915.pdf
[6] http://www2.isda.org/attachment/Nzc3Mg==/Submission%20CCIL%20Deafult%20Handling_final.pdf
[7] https://www.ccilindia.com/Documents/whats_new/2016/Consultation_Paper_CCIL's_SIG.pdf
[8] ISDA response is not publicly available as of date.

choose to use this optimized process, and what the conditions are for opting in or out of this process. Our members would like to ensure that clearing members will still be able to withdraw any excess collateral from each default fund, as is the existing practise.

Our members also request CCIL to provide more information on contingency processes. For example, if the optimisation process is not completed due to technical or operational issues at CCIL, what rights will clearing members have to make up the shortfall in the default fund, and how will clearing members be informed of this? If clearing members are not informed of such issues promptly, the existing deadline of 11 AM IST the next working day may not be sufficient to make up the shortfall, and our members respectfully submit that an extension of the deadline be built into the contingency plan to factor in such delays.

There is also lack of clarity when it comes to a shortfall in the default funds of more than one segment. Paragraph 3.1.2 of the Consultation indicates that *"such shortfall will be sought to be replenished from the surplus balances in the default funds of other segments in the ratio of the shortfalls. However, depending on market exigencies, such surplus balance may also be utilized to meet shortfall in default fund of specific segment(s) only"*. We request CCIL confirm that the surplus will be allocated equally amongst the default funds with a shortfall, or will CCIL specify a ratio for the allocation? Our members would also appreciate clarity on what the market exigencies referred to are defined as, and which specific segments will be given prioritization in such circumstances. Our members would request CCIL to define these circumstances upfront, so that clearing members will be prepared in case of such exigencies.

With reference to the CBLO segment, our members would request that CCIL approach this process in a phased manner, and implement this optimisation process for the CBLO segment after it has been implemented for the other segments. This is due to the unique separation of risk management processes for the CBLO segment compared to the other segments, and our members are not supportive of any steps to mix collateral provided in respect of the default funds of the CBLO segments and the other segments until there is more clarity on how this process would work in practise, and the operational considerations which we have sought clarity on. The mixing of collateral between the CBLO segment and the other segments should only be considered to the extent the risk management of the segments is no longer separated, which does not appear to be the case at this time.

*Meeting the deficit in default fund for a segment from surplus balance in Securities Segment SGF*

With reference to section 3.2 of the Consultation, while not directly covered under this Consultation but factored in by our members when formulating a response, is that CCIL is not in line with other CCPs in permitting clearing members to provide securities to cover variation margin requirements in the Securities Segment SGF.

We have received feedback from certain members that CCIL should align with other CCPs in their margin requirements, and restrict variation margin collateral to cash. In this regard, they also request that CCIL ensures that interest on cash margin is determined on a price alignment basis in order to reduce current funding differentials. The present system effectively leads to a one-way margining system under the current MTM credit system that is followed by CCIL, which does not align with that of other CCPs and is another area where members are looking to CCIL to effect changes that lead to closer harmonization with other CCPs.

However, we have also received feedback from other members who are of the opinion that the securities permitted by CCIL to cover variation margin requirements, with an appropriate haircut, are equally robust and should therefore be permitted.

These concerns that we have highlighted are inextricably linked with any discussion regarding the Securities Segment SGF, and our members would request that CCIL have further discussions with stakeholders to arrive at a consensus before implementing the proposal to meet the deficit in a default fund from a surplus balance in the Securities Segment SGF. As this point illustrates, it is therefore vital that CCIL continues to engage the industry and provides clarity on these issues. This will help CCIL develop a more robust framework, as well as harmonize with other CCPs globally.

It is also important to note here that the Securities Segment SGF is made up of collateral deposited by members towards their initial and variation margin contributions. Margining is a risk management measure designed to cover the potential losses if a default occurs under normal market conditions, and is defaulter specific. This means that margin pledged by the defaulting clearing member prior to default will be used to cover any loss resulting from its default. Margin pledged by non-defaulting clearing members will not be used to cover default losses created by other clearing members, i.e., margin is non-mutualized.

On the other hand, the default fund is designed to cover excess losses in a default that occurs under extreme market conditions, and the default fund is made up of contributions from both clearing members and CCIL's Skin in the Game (**SIG**). Unlike margin, default funds operate on a "pooled" basis, which means non-defaulting clearing members may be required to share any losses due to a default of another clearing member, i.e., the default fund is mutualized.

As highlighted above, our members are concerned with the conflating of mutualized and non-mutualized resources, and are of the view that the risk management and optimization of mutualized and non-mutualized collateral pools should be kept separate at all times.

This is especially the case given the fact that CCIL is not currently able to provide clearing members with information on which specific securities are unencumbered at any time. This lack of information, when it comes to collateral provided in respect of variation and initial margin, would be exacerbated should CCIL start trying to automatically allocate unencumbered collateral to meet a deficit in the default fund of a particular segment, and we respectfully submit that CCIL carefully consider this aspect of the Consultation once a consensus with the current system of margining in the Securities Segment SGF is reached.

*Additional appropriation from unencumbered CBLO collateral to meet the shortfall in default fund in CBLO segment*

With reference to section 3.3 of the Consultation, for the reasons enumerated above, our members request that CCIL address the lack of a consensus around the current margin framework followed by CCIL before implementing the proposal to meet the shortfall in the default fund of the CBLO segment from unencumbered CBLO collateral. We would also like to reiterate that our members are concerned with the conflating of mutualized and non-mutualized resources, and are strongly of the view that the risk management and optimization of mutualized and non-mutualized collateral pools should be kept separate.

*Other comments*

As noted above, 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:

- CCP Recovery and Resolution Mechanism[9] submitted on September 25, 2015; and
- Default Handling: Auction of Trades & Positions of Defaulter[10] submitted on January 19, 2015.
- Proposal to Resize CCIL's 'Skin in the Game' and Restructure Default Waterfall[11] submitted on December 15, 2016[12].

[9] http://www2.isda.org/attachment/ODI2Nw==/India_250915.pdf
[10] http://www2.isda.org/attachment/Nzc3Mg==/Submission%20CCIL%20Deafult%20Handling_final.pdf
[11] https://www.ccilindia.com/Documents/whats_new/2016/Consultation_Paper_CCIL's_SIG.pdf
[12] ISDA response is not publicly available as of date.

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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.

However, our members are especially concerned with the lack of response or indication from CCIL on implementing an auction mechanism for the default handling process since the consultation, which was over two years ago. We would urge CCIL to continue dialogue with members on the auction mechanism, as it is imperative that clearing members have certainty on the auction mechanism that CCIL is planning to implement. It is important to note that our members opposition to the auction reserve price mechanism remains as strong now, as when we made our submission on January 19, 2015. While not directly related, it is also important to note that CCIL's default handling mechanism involves bilateral trade tear-up as a primary mechanism for close out. This is a point of concern for members who trade on an anonymous platforms, as they cannot manage who their trades are matched with.

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

ISDA thanks 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,

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

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