Public Comment on Consultation Report on Unregulated Financial Markets and Products

Executive Summary

CCP12 welcomes the initiatives taken by IOSCO and other market regulators in continuing dialogue with the industry on the provisions of central counterparty (CCP) services for an expanded range of asset markets. CCP12 is strongly supportive of such initiatives, and in general:

- States that CCP clearing houses provide a critical risk mitigation function and in doing so decrease systemic risk and increase integrity of financial markets;
- Notes that CCPs have been responsive to industry demand, that over the past decade CCPs have extended services into a range of OTC markets, and that some CCP12 members are now actively moving forward with more services for the OTC markets;
- Believes there is an important role for regulators in education and promotion of CCP clearing of OTC products, where such initiatives facilitate systemic benefits; and
- Believes that international co-operation and co-ordination between regulators is necessary to increase efficiency, reduce duplication, and minimise potential conflicts in statutory obligations.

CCP12 remains committed to ongoing dialogue with industry stakeholders and regulators regarding enhancement of standards and practices in the context of evolution of the CCP industry.

CCP12 Background

CCP12 – the Global Association of Central Counterparties, was formed in 2001, and is currently comprised of some 24 major central counterparty (CCP) clearing house organisations across Europe, Asia and the Americas. These members operate over 30 separate CCPs across an extensive range of OTC and exchange-traded markets, both cash and derivatives, covering equities, fixed interest, commodities and energy.

Our membership has a broad range of experience, and includes several CCPs that have been instrumental in the development and establishment of CCP services for OTC derivatives, including credit default swaps (CDS). Our membership also includes CCPs who are reviewing their current offering of CCP services and may decide to offer OTC clearing services in future; and those that have considered extensions but are currently focusing on maintaining their current product offering. The experiences of our Members have shown that while CCPs must remain receptive to extensions in their business, it must ultimately be a decision based upon the balance of risk and relevant commercial appetites of each individual CCP.

It is with this background that CCP12 puts forward its submission on **Recommendation Four** and **Recommendation Five** outlined in the Consultation Report.

1. Response to Recommendations in the Consultation Report

CCP12 strongly supports the analysis and conclusions in the IOSCO Consultation Report. Each of the specific issues raised in Interim Recommendations Four and Five are addressed below.

Interim Recommendation #4:
IOSCO encourages industry responses in the CDS market and recommends the following regulatory responses:

> ***1. Provide sufficient regulatory structure for the establishment of CCPs to clear standardised CDS, including requirements to ensure:***
> ***a) appropriate financial resources and risk management practices to minimise risk of CCP failure;***
> ***b) CCPs make available transaction and market information that would inform the market and regulators; and***
> ***c) co-operation with regulators;***

CCP12 Response
CCP12 supports regulatory initiatives to promote the use of CCPs where deemed beneficial by market stakeholders, or desirable in the context of wider systemic importance. CCP12 Members are cognisant that appropriate financial and risk management practices are essential for market confidence in any CCP, and will continue to rely on strong existing risk management capabilities while working with industry partners and regulators to develop further risk mitigation mechanisms where appropriate.

The proposal to increase market transparency can play an important role in the operation of a fair and orderly market. Careful consideration should be given as to what information is required to be provided by CCPs for the market: separate analysis must be undertaken relating to prices, trades, and positions (or "open interest") and there must be clarity over what data can be disclosed to market participants, as a function of market participant demand, versus what information is required by regulators where the system is systemically important. Moreover, industry solutions already exist - including the trade information warehouse infrastructure operated by at least one CCP12 member - that capture transaction and market information (including trades that may not be cleared by a CCP), thereby facilitating information provision to the market and regulators in a transparent and efficient manner.

CCP12 Members also note the important role for regulators, in conjunction with CCPs, with respect to market education. Where initiatives relate to systemic benefits, CCP12 Members believe there is a strong role for regulators to educate industry stakeholders, and where necessary, to publicly endorse and support such initiatives.

> ***2. Encourage financial institutions and market participants to work on standardising CDS contracts to facilitate CCP clearing.***

CCP12 Response
The benefits that CCP clearing provides in developing market depth and efficiency - most recently reinforced in relation to the central clearing by relevant CCP12 members of OTC contracts following the Lehmans default - have been well documented,[1] and CCP12

[1] These benefits and others are comprehensively outlined in "The Value Proposition of CCPs," a paper published by CCP12 in March 2009 – copy attached.

Members support industry initiatives to standardise CDS (and other OTC contracts) to facilitate CCP clearing.

However, CCP12 notes that:

- Bespoke contracts offer an important hedging and risk mitigation tool for a number of market participants. Standardisation should not undermine the important function of such bespoke OTC contracts.
- CCP clearing relies on a number of pre-requisite product characteristics in addition to standardisation, for instance, liquidity and accepted pricing models. Standardisation alone, while necessary, is not necessarily sufficient to enable CCP clearing of a particular asset class. We caution, moreover, that there is no absolute definition of "standardised" and what characteristics of a market make it suitable for CCP clearing. While (as the Consultation Report notes) it is for each CCP to determine what products to clear, each CCP will make its own separate determination, taking into account relevant factors including the product characteristics, user demand, risk and default management structures, loss-sharing mechanisms and regulatory approval. It is possible, and not necessarily wrong, that one CCP may decide that a product is *not* sufficiently standardised as to be capable of clearing, while another CCP decides that it *is* sufficiently standardised. The fact that any specific CCP decided to offer clearing of a particular CDS or other product cannot be taken as evidence that such a product is therefore suitable for clearing by all CCPs who wish to do so.

3. CPSS-IOSCO Recommendations for CCPs should take into account issues arising from the central clearing of CDS.

CCP12 Response

The CPSS-IOSCO Recommendations for Central Counterparties have been the *de facto* global benchmark for CCP operations and risk management since their introduction in 2004, and CCP12 provided a constructive industry contribution to their development during 2002/3. CCP12 Members support a review of the Recommendations to reflect changes in the industry since their introduction, including but not limited to CDS clearing services, and CCP12 looks forward to working with CPSS-IOSCO on this initiative.

We note the recent ESCB/CESR draft recommendations have made substantial in-roads on the issues around CDS clearing; consequently, there may be scope for CPSS-IOSCO to build upon this work into a more general framework for clearing of OTC derivatives products. As highlighted in the Consultation Report, CDS products represent only 10 per cent of the overall OTC derivatives market. Further, the CDS market is at different development stages throughout the world, and as such, greater benefits may derive from a more generalised review of the Recommendations.

4. Facilitate appropriate and timely disclosure of CDS data relating to price, volume and open-interest by market participants, electronic trading platforms, data providers and data warehouses;

CCP12 Response

Efforts to improve transparency are broadly supported by CCP12 Members. However, such efforts may have to take into account the market impact of transparency. At minimum, appropriate transparency to regulators has to be achieved.

5. Establish an appropriate framework to facilitate information sharing and regulatory co-operation between IOSCO members and other supervisory bodies in relation to CDS market information and regulation;

CCP12 Response
CCP12 is strongly supportive of a clear and consistent regulatory framework between supervisory regimes. As highlighted above, whilst a number of CCP12 Members have established CDS CCP services, other Members have found that such services do not meet their risk appetite, or would not be sustainable in their respective markets.

Where the asset market is global, regulatory co-operation would be essential not only to prevent arbitrage across jurisdictions, but also to increase efficiencies and reduce duplication. The regulatory regime should accommodate appropriate levels of cross-border interaction, reflecting the nature of the marketplace rather than national borders.

CCP12 is supportive of co-operation between national regulators to minimise potential conflicts in statutory obligations. Where the asset market is domestic or regional, co-operation between relevant regulators may facilitate provision of CCP services into markets that might otherwise be unsustainable independently.

6. Encourage market participants' engagement in industry initiatives for operational efficiencies.

CCP12 Response
CCP12 acknowledges the progress that has been made by both the sell-side and the buy-side, and the commitments made both to the US and European authorities, most recently in the letter addressed to the Federal Reserve Bank of New York dated 2 June 2009. That letter demonstrates that the current bilateral network arrangement of OTC clearing still offers a number of challenges, particularly in the area of electronic trade matching, collateral management and portfolio compression. While bilateral networks can be appropriate for initiation of services and protocols between relevant counterparties, as a market matures, and an increasing number of counterparties join the system, the maintenance and upgrading of such a system becomes complex.

As noted above however, bilateral systems are often well developed within individual organisations. CCP12 Members believe regulators have an important role in promoting and encouraging industry participants to support centralised clearing initiatives, particularly when the benefits relate to systemic risk reduction.

Interim Recommendation #5:
IOSCO recommends that jurisdictions should assess the scope of their regulatory reach and consider which enhancements to regulatory powers are needed to support TC interim recommendation #4 in a manner promoting international co-ordination of regulation.

CCP12 Response
As outlined above, CCP12 Members support the international co-ordination of regulation. Such initiatives are important where the asset market is global (or concentrated in particular countries), or where domestic markets could not independently maintain a CCP. A lack of such co-ordination may result in a sub-optimal number of CCPs, or impose undue constraints on domestic market development.

Attachment – "The Value Proposition of CCPs" – March 2009

About CCP12
Formed in 2001, CCP12 is a global association of 24 major central counterparty clearing house organisations across Europe, Asia and the Americas. CCP12's mission is to collaboratively share information, support development of standards and liaise with regulators, industry groups and global market users to foster dialogue on areas of mutual interest and concern, and to promote best practices in CCP risk management and operations.

For further information about CCP12 activities or to enquire about joining CCP12, please contact the current Chair, Ms Anne T. Brown, Chief Risk Officer of the Australian Securities Exchange at 612 9227 0233 or via anne.brown@asx.com.au .

THE VALUE PROPOSITION OF CENTRAL COUNTERPARTY CLEARING HOUSES

EXECUTIVE SUMMARY

This paper – produced by CCP12, the global association of central counterparties – summarises the value proposition of central counterparty clearing houses (CCPs).

Clearing houses contribute significantly to the efficiency of financial markets and in doing so cut the average costs of trading and increase the profitability of their users. Where they become central counterparty, clearing houses also provide a critical risk mitigation in those markets and in doing so increase the capital efficiency of their users. These benefits in terms of efficiency and risk mitigation have been particularly important in recent times given the global turmoil in financial markets post sub-prime.

The paper begins with some definitions before considering the benefits provided by CCPs in their roles as both clearing houses and central counterparties. It then reviews the role and value of CCPs in times of market turmoil, before concluding by considering the future value proposition of CCPs.

DEFINITIONS

A **clearing house** is an organisation that establishes and records obligations arising from trading on a marketplace and ensures that those obligations are processed according to the relevant rules. This may involve interfacing with a central securities depository (CSD), or similar settlement facility, to ensure that the trades are settled. It may also involve netting of those trades prior to settlement.

A clearing house acts as a **central counterparty** when it interposes itself, directly or indirectly, between the transaction counterparties in order to assume their rights and obligations, acting as the direct or indirect buyer to every seller and the direct or indirect seller to every buyer. The most common, but by no means only, legal process to achieve this is called "novation", in which two new contracts are created – between the CCP and the buyer, and the CCP and the seller – to replace the single, original contract between the two parties. In most cases, CCPs act as central counterparty on a principal-to-principal basis, meaning that the buyers and sellers are participants (or members) of the clearinghouse, rather than their underlying clients.

THE BENEFITS OF A CLEARING HOUSE

> "Post-trade clearing and settlement are … the central nervous system of the financial system … [and] ... are critical for the performance of the economy."
> Federal Reserve Bank of Chicago, Economic Perspectives, Q4 2006

Clearing houses improve the efficacy of financial markets and thereby lower the average cost of trading by making trade processing more efficient because they:

1. **Standardise and automate trade capture and post-trade processing**, removing the need for bilateral, potentially manual reconciliations, reducing processing errors and operational risk, and providing straight-through-processing (STP) to back office systems.
2. **Provide a "golden record" of each trade**, its status, and payments relating to it – including such events as coupons and corporate actions – thus reducing processing errors and disputes and operational risk.

3. Provide, in the form of their rulebooks, a standard set of conditions of business, thereby **minimising legal risk**.
4. Provide, or interface with, **robust payment systems**.
5. Sustain, where the trade execution process itself is anonymous, **full post-trade anonymity**.
6. Perform, or enable CSDs to perform, **netting of payments and settlements**, thereby reducing settlement obligations and systemic and liquidity risks.
7. Provide, where necessary, **efficient portfolio management mechanisms** (e.g. transfers, close-outs, tear-ups etc.).
8. Provide systems and procedures, and centralised investment therein, which ensure **high capacity, low latency and low operational risk in trade processing**.

THE BENEFITS OF A CENTRAL COUNTERPARTY

> "there are good reasons to suppose that a central counterparty can insulate a market against crisis … A central counterparty can also provide a bulwark against more indirect forms of market contagion during a crisis."
> Bank of England, Financial Stability Review, June 1999

A CCP benefits its participants – including their profitability – and the wider marketplace because it can:

1. **Mitigate against counterparty credit risk and facilitate multilateral netting of exposures** through the legal or technical substitution of one high quality counterparty (the CCP) for many, potentially lower quality, bilateral counterparties; this also has the effect of reducing the need for credit analysis.
2. **Reduce risk by netting exposures** to that single (central) counterparty, thus reducing the market-wide requirements for collateralisation (when compared to a bilateral market).
3. **Increase certainty** by:
    a. acting as central counterparty through to contract expiry and, where relevant, even to contract delivery;
    b. providing participants with information on its role and the risks associated therewith; and,
    c. being itself subject to transparent and effective regulation and oversight.
4. Where such techniques are applied, **improve the management of replacement cost risk** within a market through the marking-to-market of unsettled trades and the use of margin; such centralised mark-to-market and collateralisation disciplines also reduce back office and legal effort and costs.
5. **Reduce the potential systemic impact of a default** by undertaking to maintain adequate combinations of margin, liquidity, capital or other financial resources to deal with such an event without impacting other participants.
6. **Reduce uncertainty around a default event** – and the need for bilateral action by participants – by having procedures for dealing with such an event which are clearly defined, transparent and, where possible, protected by insolvency law.
7. **Reduce balance sheet usage** by reducing exposures on the asset side of the balance sheet and by reducing the allocation of capital to support trading on the liability side.
8. By reducing the allocation of capital, **give participants the opportunity to improve their own credit standing** by retaining the capital and thus reducing funding costs and increasing their attractiveness to clients; an improved capital position can also assist in maintaining or enhancing credit ratings.

9. **Increase the effective capacity, volume, liquidity and product innovation of the marketplace** through netting exposures and reducing the capital required and balance sheet used to support participants' trading activity.
10. **Reduce spreads** since anonymity reduces the market impact of position unwinds, while reduced balanced sheet, capital and credit line usage will also be reflected in execution.
11. **Increase return on capital and risk-adjusted return on capital** by reducing operational costs and potential credit losses and by lowering capital allocated.
12. Help regulators to **instil capital adequacy and operational best practice** through requirements on its participants, thus ensuring that risk is allocated to a wider constituency that is able to bear it.
13. **Assist participants in managing their own risk** through the setting of market minimum margin rates and collateral acceptability standards as well as other risk management disciplines such as intraday calls and stress testing.

CCPs IN TIMES OF MARKET TURMOIL

> "the CCP acts as a kind of 'shock absorber' to the market in the event of the default of one or more market participants, allowing the net market impact of such an event to be managed with the least disruption. Recent events with the Lehman bankruptcy (and many earlier incidents) have proved that this approach works extremely well."
> Mark Yallop, Group Chief Operating Officer, ICAP plc, November 2008

Over recent history, CCPs globally have proved themselves to be robust over a set of market-wide events including extreme price volatility and participant defaults.

In terms of extreme price volatility, this has included historic events such as the 1987 stock market crash as well as more recent events such as the sub-prime credit crash. The resilience of CCPs in times of extreme price volatility is enhanced by the fact that CCPs are only exposed to clearing participant default, not to market risks or losses of their clearing participants which fall short of causing the default of those participants.

In terms of participant defaults, major global CCPs have survived defaults of clearing participants such as Drexel Burnham Lambert (1990), Barings (1995), Griffin (1998), Enron (2001), Refco (2005) and Lehmans[1] (2008). In all cases, major global CCPs coped with these default events by closing-out or transferring the positions of the defaulters, without impacting other participants, and within the margin and other financial resources available to them. Anecdotally, the certainty about counterparty creditworthiness provided by CCPs also helped market activity to continue despite, and recover from, these events.

Participants of CCPs internationally have themselves proved robust in recent years against defaults of large clients such as LTCM (1998) and Amaranth (2006).

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[1] The collapse of US investment bank Lehman Brothers in late 2008 precipitated a one day fall of around five per cent in major equity market indices, and falls of around ten per cent in major banking stocks. During this time CCPs around the world inherited Lehman Brothers' securities market positions as the bank defaulted on its obligations. Despite the massive market turmoil, CCPs unwound, hedged, liquidated, and transferred millions of positions and client accounts worth trillions of dollars, providing stability and certainty to already fragile markets. More information will be available in a separate CCP12 paper "*Central Counterparty Default Management and the Collapse of Lehman Brothers*" to be published shortly.

THE VALUE PROPOSITION OF CCPS – THE FUTURE

> "a top priority for The President's Working Group on Financial Markets … is to oversee the implementation of central counterparty services for CDS … [which] could be an important step in reducing the counterparty risks inherent in the CDS market, and thereby help mitigate potential systemic impacts."
> Erik Sirri, Director, Division of Trading and Markets, SEC, November 2008

The benefits of central counterparty clearing services outlined above have been emphasised by the credit crisis of 2007 and 2008. There is an increasing recognition that these services have a wider application than exchange-traded markets. Building on prior developments in the clearing of over-the-counter (OTC) bilateral markets, several CCPs have launched initiatives to clear credit default swaps (CDS), securities lending, energy trading and other traditionally bilateral markets. Some prior initiatives of this type have tended to involve clearing services where the clearing house does not become CCP. However, they are now tending, given the focus on credit risk, to include CCP services. This trend – towards OTC business being cleared by CCPs – is likely to continue given the demand from regulators and market participants for such initiatives.

ABOUT CCP12

Formed in 2001, CCP12 is a global association of 23 major CCPs in Europe, Asia and the Americas. CCP12's mission is to share information, support development of standards and liaise with regulators, industry groups and global market users to foster dialogue on areas of mutual interest and concern and to promote best practices in CCP risk management.

For further information about CCP12 activities or to enquire about joining CCP12, please contact the current Chair, Ms Anne Brown, Chief Risk Officer of the Australian Securities Exchange at 612 9227 0233 or via anne.brown@asx.com.au .