



# **FIA Global CCP Risk Position Paper**

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In their 2009 Pittsburgh summit, the G20 committed to clear all standardized over-the-counter derivatives through central counterparties (**CCPs**). CCPs have become subject to increased scrutiny from regulators and market participants due to their systemic importance in global financial markets and their role as a pillar of global financial reforms. This Paper addresses the risks that CCPs bring to clearing members (**CMs**), their clients and the market generally (broadly referred to as **CCP Risk**). CCP Risk includes but is not limited to credit, liquidity, operational and legal enforceability risks. Many issues relevant to CCP Risk have been identified and discussed by regulators, supranational regulatory bodies, industry groups and specific industry participants. FIA Global supports many of the existing initiatives to the extent that they are consistent with the themes identified in this Paper. For the purpose of this Paper, FIA Global has sought to move beyond the substantive debate of individual issues to identify the themes it believes are key to addressing the concerns and objectives identified by and most relevant to FIA Global's CM membership and their clients, (together, **Participants**) are directly and materially exposed to CCP Risk.

FIA Global, the alliance of FIA, FIA Europe and FIA Asia, is the primary global industry association for centrally cleared futures, options and swaps. FIA Global's membership also consists of the major global futures exchanges, clearinghouses, trading platforms, technology vendors, legal services firms and consultancy firms that, together, make central clearing possible. FIA Global's core members are CMs. FIA Global's CM constituents manage their risk and their clients' risks through clearing on CCPs worldwide.

This Paper represents the views of those members of FIA Global who act as CMs. CMs serve a uniquely important role in the context of clearing generally. They provide market access to clearing, risk management of their own and their clients' positions and bear many costs and risks associated with clearing. They are also expected to perform a crucial role in times of CCP distress by participating in the default management process as well as shouldering losses caused by the default of other CMs and their clients. In light of their participation in CCP structures, their direct and material exposure to CCP Risk across global financial markets and their own regulatory obligations, CMs are uniquely placed to assess and provide input on how better to address CCP Risk.

## EXECUTIVE SUMMARY

Central counterparties form the foundation for a healthy clearing system. As a gateway and a backstop to the marketplace, clearing members are uniquely positioned to assess CCP Risk and make recommendations to improve risk management. In the event of a default, our goal is to minimize systemic consequences while maintaining the liquidity and effectiveness of our markets, allowing market participants to continue hedging their risk.

The paper is organized into three primary components which should underpin the assessment and management of CCP Risk, including:

- Enhancing Participants' ability to assess CCP Risk through improving transparency and consistent disclosures
- Ensuring continuity through clearly defined loss allocation tools and effective resolution plans and ensuring limited participant liability to avoid assumption of uncontrollable CCP Risk
- Enhancing CCP governance to reduce conflicts of interest, manage risk assumption and improve risk controls and management oversight

Within these themes, FIA Global has developed detailed recommendations to improve the assessment and management of CCP Risk. Highlights of these recommendations follow:

### **1. Enhancing Participants' ability to assess CCP Risk through consistent and transparent CCP disclosures.**

To assess CCP Risk, clearing members and their clients require consistent and transparent information about CCP procedures, rules and risk methodologies. FIA Global recommends that CCPs adopt consistent rulebook structures that articulate key concepts with greater clarity. CCPs must provide transparency and certainty with respect to their assessment and management of risks both before and after a Participant default.

### **2. Ensuring initial margin requirements are effective, transparent and predictable to all participants, and requiring CCPs to increase margin levels where they are determined to be inadequate.**

Initial margin is the foremost risk mitigation technique in a CM default scenario to avoid broader losses, systemic consequences and ultimately the need for recovery and resolution. If a CCP calculates and calls for sufficient initial margin, the likelihood of needing to utilize the default fund or enter into a recovery scenario is greatly reduced. The determination of initial margin requirements must be effective, transparent and predictable to all Participants. FIA Global recommends higher initial margin requirements, where they are inadequate, to minimize broader consequences from a default. FIA Global feels strongly that CM initial margin (for both house and client accounts) must be more robustly protected. Using initial margin haircutting as a loss allocation tool or as a recapitalization resource should not be permitted under any circumstances.



### **3. Avoiding wind-downs and liquidations by prioritizing the continued operations of CCPs using clearly-defined loss allocation tools and effective resolution plans.**

Continuity of a systemically important CCP service is always preferable to a wind-down or liquidation of the CCP as a whole. FIA Global believes CCP continuity can best be achieved by ensuring legally enforceable limited recourse CCP services, appropriate liquidity assessment and management, proper use of recovery tools and limited liability for CMs in respect to those aspects of CCP Risk which they are unable to control or manage. A CCP's framework must be designed to foster manageable and transparent loss mutualization and CM participation in the CCP recovery effort.

### **4. Reducing conflicts of interest, aligning incentives, and improving risk management through enhanced CCP governance.**

Enhanced CCP governance will act to reduce conflicts of interest and better allow for risk assumption and management for both CCPs and Participants. In the event of a capital loss, Participants may have more at stake than the CCPs themselves. FIA Global recommends that CMs have meaningful input into CCP governance decisions, such as a CCP's level of risk assumption and the clearing of complex products. Moreover, there must be clear procedures and consequences for a CCP that does not accept such input. We encourage regulators to collaborate with CCPs and Participants to determine appropriate sizing for a CCP's skin in the game so it is aligned with Participants' interests.

## **FIA GLOBAL RECOMMENDATIONS**

### **1. More Transparency and Consistent Disclosures**

#### ***Transparency and consistent disclosures as overarching themes.***

Transparency and consistent disclosures are overarching themes that are relevant to most of the points raised in this Paper. CCPs must disclose sufficient data and provide sufficient certainty regarding their procedures, rules and risk methodologies for Participants to assess CCP Risk. Without adequate transparency and disclosure, Participants may be faced with credit, liquidity, operational and legal enforceability risks that they are unable to identify, let alone manage. Clearing entails Participants outsourcing the management of certain of these potentially concentrated, opaque and unquantifiable risks. Transparency is required with respect to the operations of a CCP both before and after a Participant default. Consistency across CCPs regarding mandatory data disclosures will further assist Participants in making meaningful assessments of CCP Risk across jurisdictions. Improved assessments of risks across jurisdictions by Participants will protect the broader global market, ensuring greater confidence and financial stability if a stress event occurs.

#### ***Pre-default data transparency.***

Participants must have sufficient data to evaluate fully the CCP's use of risk mitigation tools and the adequacy of its loss absorbency resources where those risk mitigation tools prove inadequate.

FIA Global strongly supports the publication by CPMI/IOSCO of their requirements for public disclosure regarding a CCP's financial condition, resources and performance. We believe that further enhancements to these requirements will allow Participants to assess CCP Risk more fully and, in particular, to determine how well a CCP is managing its risk. For example, in addition to the requirements set forth by CPMI/IOSCO, CCPs should also be required to disclose detailed information for each clearing service regarding their stress test scenarios for calibrating the size of the default fund and liquidity resources by notifying Participants of the assumptions, risk factors and shock levels that their risk models take into account. It is also critical that CCPs provide full transparency on the manner in which initial margin requirements are calculated for each relevant clearing service. This will allow Participants to better assess their risk exposure to a CCP at the clearing service level. Transparency will also assist in mitigating any unanticipated procyclical impact of initial margin calls as Participants will be able to anticipate and model increased initial margin requirements with respect to the products they clear if they understand how a CCP's risk model works. For further discussion of FIA Global's recommendation regarding increased initial margin as the foremost risk mitigation technique in a CM default scenario, see "Initial margin" below.

Ex-ante certainty and predictability regarding the resources and measures available to a CCP in the event of a CM default are necessary for Participants to understand and effectively manage their risks and obligations. CCPs should be required to identify all the material risks they are exposed to and disclose how the CCP assesses and allocates losses associated with each of these risks. In addition to CM and client default risk, Participants must be able to understand how the CCP assesses and allocates non-default losses (including custody and investment risks, liquidity risk and general business risks such as those arising from fraud, IT, tax, employment or operational problems). For a discussion of FIA Global's recommendations regarding limitations on the losses that can be allocated to CMs, see "Limited liability and requirements for default fund capital" below.

***Post-default transparency.***

It is also crucial that Participants understand with certainty how a CCP will allocate risk in the event of a significant CM-related distress or a default scenario. This includes transparency as to which recovery tools a CCP may use to allocate its post-default losses in respect of the relevant clearing service and in which order; allocation of those losses between client and house positions; what measures it may or must take to promote continuity of its unaffected services and how Participants will be compensated for losses allocated to them. Participants must be able to understand the level and structure of a CCP's contribution(s) to the loss absorbing resources of the CCP (Skin in the Game or SITG) in respect of the relevant clearing service. To the extent that there is more than one tranche of SITG—one of such tranches attaching prior to financial resources contributed by non-defaulting CMs and the other tranche after extinction of the default fund—all Participants (not just CMs) will be better able to evaluate the extent to which the CCP is motivated to avoid exhaustion of the default fund where this is adequately disclosed. For further discussion of FIA Global's recommendations regarding SITG, see "Skin in the Game" below.

The trigger for the use of CCP emergency powers (in particular, those which might unexpectedly impact the legitimate expectations of Participants, including the right for a CCP to unilaterally change its rules or standard practices or take actions such as forced allocation or invoicing back, in contrast to more transparent loss allocation tools such as Gains Haircutting, as defined below) must be clear

and transparent in order for Participants to trust and participate in the recovery process. Where that is not the case and Participants cannot quantify with certainty the risks they are exposed to, they will be motivated to withdraw their unprotected financial resources in a distressed scenario rather than work to ensure continuity of the relevant clearing service or the CCP generally. If a CCP is equipped with comprehensive, effective and transparent recovery tools, the need for emergency powers to manage a CM default should be eliminated. Therefore, FIA Global believes that for CM risk management purposes, a CCP should not have emergency powers for use in connection with a CM default. Emergency powers should only be permitted in extreme and unanticipated situations and limited to circumstances unrelated to CM default or distress, where appropriate governance processes (involving relevant regulators and/or CCP Risk committees with adequate Participant representation) with respect to the use of such powers are in place.

***CCP rulebook structure consistency.***

As one tool to implement a more transparent framework for Participants, FIA Global proposes more consistent rulebook structures. Currently, the structure and content of CCPs rulebooks is highly inconsistent and fragmented; the provisions lack clarity and CCP rights and obligations are sometimes ill-defined, particularly regarding CCP Risk issues. This gives rise to legal uncertainty and increased litigation risk. Certain key concepts should be articulated with greater transparency and in a more consistent format, both structurally in CCP rulebooks and in the use of defined terms, including:

- Default waterfall mechanics
- CM and CCP events of default
- The extent to which the CCP segregates assets and manages risk in respect of each relevant clearing service
- The CCP's framework for managing margin and cash calls
- The legal basis on which a CCP holds, segregates and rehypothecates assets
- Auction processes, including specific participation requirements and ways in which CM waterfall exposures can be juniorized or seniorized during the auction process
- Other key risk management, recovery and resolution tools

We note that cross-CCP consistency would be relevant to addressing the concerns and challenges currently being discussed in the context of cross-CCP default management coordination. FIA Global recommends further industry exploration on how best to implement such coordination.

**2. Ensuring Continuity through Clearly Defined Loss Allocation Tools; Limited Participant Liability to Avoid Assumption of Uncontrollable CCP Risk**

***Continuity as the ultimate goal.***

FIA Global believes in pursuing CCP continuity and, where possible, avoiding the systemic disruption and distress which would be caused by the wind-down or liquidation of a particular CCP clearing service, or worse, the CCP as a whole. Full contract tear-up or wind-down is not a viable option for any CCP clearing service that is systemically important and vital to a market's health. CCP continuity requires isolating and allocating risk in the context of a particular clearing service to prevent contagion to other services of the CCP and non-defaulting Participants. FIA Global believes the likelihood of CCP continuity can be promoted by ensuring legally enforceable limited recourse CCP services, proper

use of recovery tools and limited liability for CMs in respect of CCP Risk, on a per-service basis where appropriate, which they may be unable to control or manage. However, as risks arising from contagion across services may not be fully mitigated by such measures, and CCP recovery may not be successful, for financial stability reasons CCPs must have robust and clear ex ante resolution plans on both a per-service and whole-CCP basis.

***Provision for non-default losses.***

In order to avoid a CCP default, CCPs must have sufficient capital and/or insurance to cover all non-default losses. CMs should not have any responsibility for these losses as only the CCP is able to quantify and manage these risks. Potential moral hazard issues arise for CCP management if CMs have responsibility for losses that are within the CCP's sole control. CM contributions to a CCP's financial resources should not be available to absorb a CCP's non-default losses.

***Prevention of CCP liquidity shortfalls.***

Ensuring that the CCP has adequate liquidity is crucial to its continued viability. CCPs should be required to calculate their potential liquidity requirements upfront, thereby minimizing the likelihood of liquidity shortfalls and the need to rely on liquidity facilities, whether rulebook-based, bank syndicated or otherwise, in a time of distress. While recognizing that CCPs must be able to adapt haircut levels to market conditions that apply from time to time, and that minimum haircuts are not a panacea, in order to prevent regulatory arbitrage FIA Global encourages regulators to set globally consistent minimum haircuts and concentration limits in respect of non-cash Participant contributions. CCPs should only be allowed to accept as non-cash collateral the highest quality liquid assets (for example, U.S. Treasury instruments) that must be capable of maintaining value throughout the economic/business cycle, and must be readily convertible into cash without imposing further liquidity pressures on CCPs in order to qualify.

To address the unlikely event that, notwithstanding these safeguards, a CCP needs access to liquidity over and above the minimum cash requirements in a pre-default scenario, this access should be pre-arranged directly with central banks where possible or otherwise with the market (preferably not from Participants or their affiliates) in the form of repo or liquidity facilities on commercial terms. In particular, FIA Global opposes the use of CCP rule-based liquidity facilities that give CCPs discretion with respect to haircuts, pricing and collateral, or which may impose requirements and costs on some CMs and not others. CM obligations with respect to liquidity must be characterized by clear and objective criteria, and CMs that provide liquidity to CCPs should be compensated for their losses and expenses. For discussion on the extent to which non-defaulting Participants' cash initial margin could be used for liquidity purposes after a CM default see "Protection of initial margin and collateral generally" below.

***CMs - Limited liability. CMs fulfill different roles within the CCP framework.***

They act as intermediaries, allowing other Participants to access clearing, in which capacity CMs-like CCPs-can act as gatekeepers and control the risks associated with their client or house positions. In this capacity as financial guarantors, CMs can and should be motivated to manage these risks. However, CMs also make financial resources and capital available to a CCP for use when the CCP faces distress following another CM's default. Only CCPs control the risks to which such financial resources may be exposed, and therefore the post-default liability of CMs in respect of such risks must be effectively and clearly limited to ensure that CMs-many of which are themselves systemically important-are not exposed to unquantifiable and unmanageable risk.

In a default scenario, it is crucial that cash calls (or default fund assessments) on CMs be limited. Any cash calls should be capped ex-ante at the clearing service level both in respect of any given default and across multiple defaults in a pre-defined period. Assessments against a CM must be proportional to existing default fund contributions as well as capped; for any single CM default, there should be a limit of one assessment call. With respect to multiple defaults, cash calls must be capped over a pre-defined period that will vary by clearing service and correspond to the appropriate amount of time in which a CM could be expected to withdraw from the clearing service, closing its own positions and transferring client positions to other CMs. Depending on the length of the relevant withdrawal period, cash calls should be limited to a maximum of two or three calls, notwithstanding that further CM defaults may occur during such period. Multiple cash calls beyond this amount for the relevant clearing service may be unreliable (if CMs do not pay on time) and could lead to procyclicality and liquidity or funding issues for Participants, thereby perpetuating systemic risk at a time of market distress. With respect to default fund contributions, CCPs should be required to have sufficient capital and the ability to replenish CCP contributions for at least two defaults per clearing service within a defined period.

We note that, at present, insured depository institutions in the U.S. (such as national banks) are restricted from taking on membership obligations in a CCP (or enter into a transaction) where the institution is exposed both legally and practically to unlimited liability.<sup>1</sup> Bank and financial holding companies are subject to even tighter restrictions on exposure to unlimited liability for CCP membership. Pursuant to the implementing rules for Section 4(c)(8) of the Bank Holding Company Act, a holding company is prohibited from providing a guarantee or otherwise becoming liable to a CCP for anything beyond trades conducted by its subsidiary for its own account or that of an affiliate.<sup>2</sup>

### ***Gains Haircutting.<sup>3</sup>***

In the remote scenario that CCP default waterfall resources are inadequate to absorb default-related losses, loss allocation tools may be a necessary last resort in the furtherance of clearing service continuity. While no loss allocation tools are ideal, FIA Global believes that Gains Haircutting is preferable over other loss allocation tools such as initial margin haircutting or additional assessments (over and above appropriately capped assessments limited as discussed above). Gains Haircutting across all Participants is effective and comprehensive in meeting any and all mark-to-market-related losses arising from a CM default, and is supportive of the goal of clearing service continuity, in part because it incentivizes CMs (and indirectly all Participants) to more fully participate in a post-default auction process. We note that Gains Haircutting cannot be used indefinitely and is only viable so long as the default management process is effective such that successful auctions are being held, there is no clear threat to financial stability and there is a clear path to recovery and recapitalization with respect to the relevant clearing service. In addition, losses must be shared among all Participants on a pro rata basis in order for Gains Haircutting to be truly comprehensive, and to create the right incentive amongst all Participants for behaviors that will aid the CCP's risk management efforts. Once losses have been

<sup>1</sup> See, e.g., OCC Corporate Decision No. 2000-07 (May 10, 2000).

<sup>2</sup> See 12 C.F.R. § 225.28(b)(7)(iv).

<sup>3</sup> As used in this Paper, Gains Haircutting is defined as a loss allocation measure whereby a CCP reduces its outstanding payment or delivery obligations in respect of a cleared contract on a pro-rata basis.

allocated, CCP rules must be clear and provide legal certainty on how affected Participants will be compensated for such losses.

With respect to initial margin haircutting as a possible loss allocation tool or recapitalization resource, FIA Global believes it is crucial to recognize that initial margin haircutting does not support continuity because it incentivizes Participants to flatten their risk by reducing their initial margin to zero. In other words, initial margin haircutting will result in a rush to exit by Participants. Instead of strengthening CCP default management, initial margin haircutting would disincentivize Participants from providing hedges, bidding in auctions and otherwise participating in the CCP's risk management efforts. Unlike Gains Haircutting, which involves the foregoing of expected future value, initial margin haircutting involves the diminution or extinction of proprietary rights in existing assets (except where title to initial margin is transferred to the CCP in the ordinary course, as to which see our comments below regarding the protection of initial margin) and raises significant legal and regulatory issues.

#### ***Partial tear-up.***

Where the default management process does not lead to a successful auction of a defaulting CM's positions (See also "Voluntary clearing and addressing the clearing of complex products" below), partial contract tear-up may be a necessary tool to re-establish a matched book. Partial tear-up is preferable to full tear-up as a means to preserving continuity of the relevant clearing service. It is also preferable to the forced allocation of contracts, as forced allocation does not correctly allocate risk to those members who bring the relevant risk to the CCP and are thus better placed to manage it. However, it is crucial that in undertaking any partial tear-up the CCP does not break netting sets, as this could create significant uncertainty and distress to affected Participants' risk, financial accounting and regulatory capital position. Participants should be compensated for any losses incurred in respect of such tear-up. However, potential mechanisms for compensation for partial tear-up need to be further explored. FIA Global recommends that while partial tear-up may be used as a CCP recovery tool when a product cannot find a market price in a default management auction, an impartial authority should oversee any partial tear-up process. Furthermore, CCPs should be incentivized to avoid the need for such tear-up. CCP rulebooks should define ex ante and, as clearly as possible, the mechanics and contract selection criteria.

### **3. Enhancing CCP Governance to Reduce Conflicts of Interest, Manage Risk Assumption and Improve Risk Controls and Management Oversight**

#### ***Conflicts of interest and CM input on CCP risk management decision-making.***

As with all market participants, CCPs are subject to conflicts of interest, particularly for-profit CCPs where the interests of stakeholders may not align with those of clearing Participants. Although CCP rules may allow CCPs to make critical governance and corporate risk management decisions without soliciting substantive input from, or requiring the consent of, Participants, those Participants may have more at stake than the CCPs themselves with respect to such decisions from a capital loss and default management perspective. This potential misalignment of interests may lead to increased CCP risk-taking in a manner that is not consistent with public interest or financial stability. Such conflicts of interest, and their negative effects on CMs and other Participants, are exacerbated by a lack of disclosure and consistent risk management frameworks. We note that the Commodity Futures Trading Commission has put in place detailed rules for the CMs it regulates regarding conflicts of interest,

but regulators have proposed only limited rules regarding conflicts of interest in the context of CCP governance.<sup>4</sup> Similarly, the Bank of England is addressing conflicts of interest in its Fair and Efficient Markets Review to raise barriers to intermediaries acting adversely to their clients or counterparties – particularly on the basis of information asymmetries. CCPs should similarly be required to identify and address the conflicting interests of commercial success and prudent risk management with more granularity.

As a general rule, CCPs should not compete on the basis of risk terms (for example, on initial margin requirements or default fund contributions). Instead, CCPs should compete on the basis of factors such as technology, efficiency and customer service. When CCPs are permitted or encouraged to compete on the basis of risk terms, or on the range of products cleared, they are not properly incentivized to align their risk management strategies with CMs and other Participants.

***Limits on CCP Risk assumption.***

It is clear that a characteristic of distressed markets is the inability of the market to provide liquidity and hedging capacity. Ultimately, no amount of cash will rescue a market if positions cannot be either transferred or resolved. It is therefore critical that CMs have confidence that their individual and collective capacity to support a market is a key input, at many levels, within the multilateral dialogue around the safety and soundness of a clearing service. It is not clear that this goal is being universally achieved today. With prospective new layers of interconnectedness through collateral and funding markets, there is a pressing need to address this. In light of the significant risks borne by CMs upon another CM's default, CMs must be given a meaningful level of input with respect to a CCP's assumption of risk, post-default risk management decisions and other corporate governance decisions which materially affect CM risk positions, such as the use of any residual emergency powers (which, as discussed above, should only be used in circumstances unrelated to CM default or distress). Moreover, there must be clear procedures and consequences for a CCP that does not accept such input. In addition, CM input must be taken into account or CMs must have a certain level of control over the level of any risk absorption they may have to provide if another CM defaults. CMs must also be given the opportunity to provide input on any change with respect to loss mutualization rules.

CMs play a crucial role in ensuring CCP continuity following another CM's default through participating in the CCPs default management process by providing hedging and risk absorption via a successful auction. Often, CCP rules mandate such participation, and penalize failure to participate. In certain instances CCPs may even have the right to forcibly allocate positions to CMs who may not trade in the relevant products and therefore lack appropriate infrastructure to manage such positions. A particular concern arises where CCPs clear products which CMs are not able fully to absorb or risk manage due to market or liquidity factors relevant to those products. CCPs should be required to set up CM committees that would provide advice on factors that would limit the effectiveness of a successful post

<sup>4</sup>See also CFTC Rule 39.10 promulgated to give effect to the core principles applicable to DCOs, including Core Principle P, under the Dodd-Frank Act, and EMIR Article 33, which requires CCPs to have procedures for and disclosures of conflict of interest (but with limited scope).

default auction. This should inform the size of a particular clearing service and the level of risk a CCP should assume in connection with it from time to time.

***Voluntary clearing and addressing the clearing of complex products.***

FIA Global believes that a CCP should only be permitted to clear a product if it has a well-articulated and highly credible default management strategy to effectively neutralize the risk in respect of that product. Such default management strategy must be able to specify the hedging requirements for any portfolio of cleared contracts with respect to such product, including the cost and timing of such hedges as would be available in stressed market conditions within the default management timeframe (recognizing that for some products in times of stress the market capacity to absorb the risk of such products may be strictly limited). We note that if Participants are unable to find or provide adequate hedges for such products in the market, they will not be able to participate in a successful default auction either. Failed default and auction processes threaten the health of systemically important and mandated clearing services (such as Interest Rate Swaps). When multiple CCPs compete to clear the same complex or illiquid products, the risk relating to such products is further exacerbated. FIA Global recommends that current CCP internal processes—as well as external regulation as relevant—are strengthened such that CCPs are not able to clear products which are unsuitable for clearing.

***Initial margin.***

CCPs are the concentration risk managers of the market under the mandated clearing regime. CMs are wholly dependent on CCPs' effective management of this risk, but have a crucial role in aiding the CCP through the lifecycle of well-functioning and distressed markets. The key to managing this risk must be through the initial margin model under a “defaulter pays” approach, but Participants generally recognize the quantitative and contextual challenges to modelling tail risks. Effective initial margin is, however, the foremost risk mitigation technique in a CM default scenario to prevent wider loss allocation or, ultimately, recovery and resolution. CCPs should prioritize the “defaulter pays” approach, where the defaulting CM's initial margin is the primary source of funds to meet the CCP's loss upon a default with respect to the relevant clearing service. In addition to greater transparency with respect to CCP initial margin requirement methodologies as discussed above, FIA Global advocates for higher levels of initial margin (where such initial margin is currently inadequate) as a means to reduce contingent liabilities. If a CCP calculates and calls for sufficient initial margin, the likelihood of needing to utilize the default fund or enter into a recovery scenario is greatly reduced. We note that the importance of sufficient initial margin to the CCP is a further argument as to why non-defaulting CMs' initial margin must be subject to adequate safeguards and why initial margin haircutting is not an appropriate recovery loss allocation tool.

Beyond the principle around initial margin and “defaulter pays,” we suggest there is a place for further structured governance around initial margin models, bringing together the quantitative and risk management experience and resources of CMs, CCP regulators and individual CCPs. Through a structured process of transparency, disclosure and periodic analysis, we believe that CCP Risk committees, CCP management, CM risk management and market regulators can be consistently and appropriately appraised of the challenges presented by any one product and any one clearing service. Consistency and transparency are essential to bringing together the necessary yet limited pool of technical expertise required. Effective summaries of such analyses can likely be usefully disclosed much wider and deeper into the market, building confidence with Participants.

***Skin in the Game.***

CCP Skin in the Game is a means to align the interests of CCPs with Participants. FIA Global believes that a CCP's contribution to the default fund should be an amount that is material to such CCP and also aligned with the amount of risk in the CCP's system. SITG should be segregated and fully funded for such purposes, and CCPs should have sufficient capital on hand to replenish their capital contributions on the same timeline (usually within a matter of days) and for the same number of defaults that CMs are required to make such replenishments. SITG or, where the CCP structures its SITG in senior and junior tranches, at least a significant portion thereof, should be used ahead of any non-defaulting CM resources in the default waterfall. We encourage regulators to collaborate with CCPs and Participants to determine appropriate sizing for SITG.

***Protection of initial margin and collateral generally.***

FIA Global feels strongly that CM initial margin (for both house and client accounts) must be more robustly protected. Cash and non-cash initial margin must be segregated and be held bankruptcy remote from the CCP, and subject to investment and custodial protections. Allowing CCPs to hold cash initial margin with central banks will reduce CCP exposure to commercial bank risk generally. Many commercial banks are CMs or CM affiliates; by keeping cash with such entities and using them for settlement purposes, CCPs are exposed to multiple levels of CM-related risk which ultimately may be borne by Participants upon a default. Permitting CCPs to maintain central bank deposits will also reduce the need for CCPs to utilize reverse repos and/or directly purchase securities to reduce settlement or concentration bank risk, which pose enormous investment challenges and risks, like forced diversification.

CM default fund contributions must be segregated and protected for each relevant clearing service such that the CCP cannot use them in respect of non-default losses or across clearing services, although the default fund contributions of a defaulting CM should be capable of being applied to losses across all CCP services. FIA Global proposes that like cash initial margin, default fund contributions be held with central banks. In terms of use of collateral, CCPs should never be permitted to rehypothecate the initial margin securities collateral of non-defaulting CMs; any use of a non-defaulting CM's cash initial margin (for example, for liquidity purposes) should be under limited circumstances only and subject to the safeguards discussed above to protect the CM's economic and legal interests in such cash initial margin.



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