Response to the ESMA consultation paper

RTS on the methodology for calculation and maintenance of the additional amount of pre-funded dedicated own resources (Article 9(15) of CCPRRR)

Introduction

The Futures Industry Association (FIA) and the International Swaps and Derivatives Association (ISDA), together the Associations, represent the largest number of global and national participants in clearing, banking and financial markets. The Associations appreciate this opportunity to comment on this consultation.

This consultation response covers the positions of our members that are clearing members and their clients. The paper does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views expressed herein.

While we welcome the addition of a second tranche of CCP equity (skin-in-the game or SITG) in the waterfall in the Level 1 regulation, we have some concerns about this being sized relative to the first tranche. In particular, we have fundamental disagreements with the sizing of the first tranche of CCP equity in CCP waterfalls, as EMIR compliant SITG can be small compared to the size of the default fund and are not sufficiently risk sensitive. As the general principle of SITG sizing is not topic of the consultation, we provide comments to the details of this RTS.

We would have preferred a simpler approach, i.e. setting the second tranche of SITG (SSITG) to 25% of the CCP's minimum capital requirement. As ESMA believes that level 1 requires a more granular approach, we agree with the proposal in principle.

However, we believe that the indicators should include more aspects of a CCP's risk management framework (like the margin methodology). We are also concerned that the calibration will lead to low levels of SSITG, even for the most complex EU CCPs.

Questions

Q1 *: Do you agree with the proposed approach to define the basic elements of the methodology for the calculation and maintenance of the additional amount of pre-funded dedicated own resources? If not, please explain why and how you would suggest changing the basic elements of the formula?*

The Associations believe that all CCPs should have SSITG sized relative to their regulatory capital and set at the maximum amount allowable under the Level 1 text, i.e., equal to the first tranche of SITG, which already would introduce a level of risk sensitivity via the inputs into the calculation of the minimum capital requirements.

In principle, we do not agree that the SSITG should be sized based on complex concepts such as "*the structure and the internal organisation of CCPs and the nature, scope and complexity of their activities*" and "*the structure of incentives of the CCPs' shareholders, the CCPs' management, the clearing members of CCPs and the clients of those clearing members*". These complex concepts cannot be easily condensed into a single number.

Incentive structures are equally complex and cannot be easily distilled to an individual number (see FIA/IIF/ISDA paper" Recovery and resolution: Incentives Analysis").

The principle of proportionality is already incorporated into the Level 1 text. The calculation of SSITG for smaller CCPs will be based on their "risk based" capital requirements, rather than the minimum capital requirement set out in EMIR Article 16

Smaller CCPs' concerns could be taken into account further by allowing them to reduce their second tranche of SITG by the same amount their first tranche of SITG is higher because of the capital floor (with a floor of the SSITG of 10% of capital).

Numerical example:

- A small CCP has a minimum risk-based capital of €6m. Its first tranche of SITG is €1.875m, driven by the capital floor of €7.5m. Without the floor, SITG would be €1.5m.
- This small CCP could be allowed to reduce their second tranche of SITG by €375k (the difference between €1.875m and €1.5m.
- SSITG would be €1.125m (this is higher than the 10% floor of €600k)
- An even smaller CCP with €4m risk-based capital would still have a first tranche of SITG of €1.875. The difference to the risk based SITG is €875k. This CCP could not deduct the full difference (€875k), as the 10% floor of the SSITG (€400k) is larger than €125k = €1m - €875k.

Notwithstanding the above, we understand that ESMA believes that the level 1 text does require more granular guidance in the form of regulatory technical standards. With that in mind we generally agree with the basic elements of the methodology.

Q2 *: Do you agree with the schematic formula combining a set of parameters assessed by the CCP? If not, please explain why and how you would suggest changing the formula?*

The Associations propose a different, more simple approach (see our response to question 1). Assuming that ESMA believes that the level 1 text requires them to propose a more granular process, we generally agree with the proposal.

However, we note that risk management frameworks of CCPs are complex and that these cannot be easily condensed into a single number.

The schematic formula in principle makes sense to aggregate a set of parameters. We are however concerned that these parameters do not sufficiently take into consideration the full gamut of a CCP's risk management framework.

Overall, we also think that the weights of the criteria should be reviewed. More emphasis should be placed on the sufficiency of the Default Fund and Initial Margin levels/methodology. For instance, contrary to the importance of financial risk management of a CCP, like margin requirements, lookback periods, margin period of risk, concentration and liquidity add-ons, default fund sizing, stress testing etc, the whole area of financial risk management is condensed down to one question about backtesting breaches (at a level that can mask a lot of margin deficiencies) and has a maximum weighting of 4%.

We also believe the indicators are calibrated at a level that is too low. We have estimated these indicators for a number of European CCPs. As we don't have visibility of many indicators, we have provided a range. The result for the CCPs we analysed are between 10% and 36%. As most of the indicators where information wasn't public can be managed by CCPs, we expect the outcome of the proposed calculation methodology to be closer towards 10%, even for complex CCPs. We will share the underlying data separately.

Q3 *: Do you agree with the list of parameters to describe the structure and the internal organisation of CCPs and the nature, scope and complexity of a CCP's business? If yes, are there additional parameters that should be added to the list? If not, please explain why and how you would suggest assessing the internal organisation of CCPs and the nature, scope and complexity of a CCP's business in the methodology?*

As mentioned before, we believe that it is very difficult to condense something as complex as a CCP risk management framework into a single number and we would have preferred a simpler approach. Assuming that ESMA believes that the level 1 text requires them to propose a more granular process, we overall agree with the proposal, but have comments to the weights of some of the indicators.

A good example is the number of asset classes cleared by a CCP. For a large CCP this indicator can add up to 5% to the indicator value and to the amount of SSITG. While we agree that the number of asset classes has a bearing on complexity and risk of a CCP, this indicator has the same or even higher weight than the only indicator covering financial risk management of a CCP (margin backtesting breaches, which has a max weighting of 4%).

Nature and complexity of the asset classes cleared

As mentioned above, we think that the number of asset classes will not necessarily make a CCP considerably ”riskier” and that this indicator’s weight should be reviewed.

In this context, it would also be helpful to define asset classes further. Would for instance OTC interest swaps be the same asset class as exchange traded interest rate futures or is this a reference to separately ringfenced segments at a CCP?

We further propose that a CCP should not be penalised for clearing several exchange traded financial asset classes under the same default fund. For instance, the indicator should not trigger for a CCP clearing equity futures and bond futures under the same default fund.

We agree that a multi-currency environment could make a CCP more complex but think that the indicator whether the CCP clears asset classes denominated in / or offer settlement in at least 1 non-EU currency is more or less duplicative to the indicator whether the CCP clears asset classes denominated in / or offer settlement in more than one currency. It does not make a difference for the risk of a CCP whether currencies are EU or non-EU currencies.

The CCP’s relationships and interdependencies with other financial market infrastructures and other financial institutions

In general, we think that not all FMIs introduce the same risk to a CCP. We agree that complexity increases with each payment system or security settlement system or custodian, but question whether trading venues introduce similar risk to the CCP.

We also don’t think that the international nature of a CCP’s membership base represents a risk factor. If at all, it provides a more diversified membership that will contribute to a more resilient environment in a crisis.

Given the additional risk of an interoperability arrangement, ESMA should consider whether a higher weight of this indicator would be appropriate.

The internal organisation of the CCP

We note that cases where the CCP’s board disregards a risk committee decision are exceptionally rare, so even one ignored risk committee decision should translate into at least 1%. We also note that this indicator only makes sense if the risk committee is comprised of a majority of clearing participants.

On the indicator that the second line of defense risk function should account for 20% of a CCPs FTEs, we are concerned about two issues:

- This parameter can be easily influenced by declaring more functions as risk functions.
- It is not clear whether there is a specific percentage of FTEs in the second line of defense which is appropriate across all CCPs. For instance, a CCP with one asset class and a very large member base will have more difficulties meeting this requirement (lots of sales and member servicing and less risk staff as only one asset class) compared to a CCP with many different

asset classes. We don't believe that the aforementioned CCP with less risk staff, should be considered more risky.

The robustness of the CCP's risk management framework

This is the area where we have the most concerns.

First, the backtesting coverage level of the CCP is usually on portfolio level, not instrument level and therefore portfolio effects can compensate for potential issues and mask breaches in some products.

Secondly, 4% seems to be low for the only indicator covering financial risk management, which is the most fundamental aspect of a CCP's function.

And lastly, we understand that ESMA chose indicators that are observable, but the choice of only one indicator disregards a lot of attributes of a CCP financial risk management, like margin requirements, concentration and liquidity add-ons, lookback periods, margin period of risk, default fund sizing, anti-procyclicality tools, stress testing etc.

We agree that operational risk is important, but again question the choice of indicators, which seem to have been picked mostly because these cover data that NCAs have available. We also believe that there have to occur many payment issues to reach a meaningful level of this indicator. For illustration, for the indicator to reach 1%, the CCP has to be concerned with 5 days of payment issues. This level of payment issues would already raise significant concerns with clearing members and could lead to some clearing members invoking measure to reduce the operational risk to such a CCP.

We also believe that payment issues are of higher concern than the processing of new trades – usually these trades will be processed after the issues has been solved and there is no significant impact on clearing participants.

And finally, we propose to add another set of indicators: These would be whether posted initial margin is bankruptcy remote or not. It would be 0% for yes and 2% for no – both for cash [0%, 2%] and securities collateral [0%, 2%].

Weaknesses identified by the CCP's competent authority

We agree with this indicator but propose a higher weight. While we don't know how often NCAs have findings with the highest priority, we assume that if there is such a finding, the indicator weight should be higher.

Q4 *: Do you agree with the list of parameters to describe the structure of incentives of a CCP's shareholders, management, clearing members and clients? If yes, are there additional parameters that should be added to the list? If not, please explain why and how you would suggest assessing the incentives in the methodology?*

<u>The CCP's ownership and capital structure (B1)</u>

Given the fact that EMIR does not require the shareholder of a CCP to support the CCP other than the capital in the CCP itself, we question the importance of whether the majority shareholder is rated or not.

We are very positive about CCP shareholders that have agreed parental financial support to the CCP. However, we are concerned that the way the indicator is set up, parental support is treated in a more positive way than providing large equity on the CCP's balance sheet in the first place:

Example:

CCP1 has 100 as equity (driven by minimum capital requirements) and 100 parental support. CCP2 has 200 equity.

CCP2, will be punished with 2% higher SSITG, while the overall capital situation is that same as CCP1, which is not subject to this indicator, despite the fact that CCP2 has the same overall resources available and for CCP2 there is no risk whether the parent will be able to provide the support when needed.

<u>Whether and to what extent the remuneration of the senior management is directly and contractually impacted following a default or non-default event</u>

We agree with these indicators. The term "senior management" should however be defined more clearly.

On the average percentage of the CCPs' senior management, the scale of the indicator (0% if the claw back applies to at least 50% of variable remuneration) will act as a de-facto cap on claw-backs for European CCPs. ESMA should consider whether 50% is the correct level for this cap.

<u>The clearing member's and client's involvement in the CCP's risk governance</u>

It would be beneficial to define the term "clearing members are involved in the investment decision process". We believe this should be defined as CCPs allowing their members to direct actual investments. We do not think that an agreement of general investment policies by the risk committee amounts to "clearing members are involved in the investment decision process". Risk committee members act for the CCP, not for their employers and the investment policy is not equal to the actual investment process.

The indicator, as drafted would assign 2% to a CCP where clearing members are involved in the investment process but would not bear investment losses. We do not believe that a CCP should be punished for not allocating losses to their customers.

A better way to frame this indicator would be: “If clearing members do not provide direct investments but the CCP allocates investment or custody losses to clearing members, an additional 2% applies.

We do not think that it is always appropriate for clearing members and clients to participate in the default management process, for instance if the CCP can close the defaulter portfolio without member involvement, for instance by selling the defaulter position at an exchange. We therefore believe that this indicator should be dropped.

Equally, it will not always be appropriate to have financial incentives or penalties to participate in auctions, for instance if auctions are not mandatory. All clearing members are automatically incentivised to participate in the auction, as the consequence of a failed auction, like partial-tear up or increased losses are likely worse for them.

In any case we firmly believe that forced allocation is not the right tool if auctions fail for the following reasons:

- Allocation can be arbitrary.
- Allocation is likely to be unequitable.
- Firms might get additional risk allocated.
- Firms might not be able to risk manage the allocated positions or pay in margin associated with the allocated positions.
- Allocation likely only to clearing members.
- No incentive for firms to restrict risk to the CCP – in fact, prudent firms might be allocated more because they “can take it”.

For this reason, the indicators should not incentivise CCPs to implement forced allocation. For more information, please refer to the whitepaper “Partial Tear-Up and Other Position Allocation Tools”[1].

We also propose an additional indicator in which CCPs that do not utilise default management groups to support the default management process should have to provide higher SSITG, given that a failure of the default management process can likely cause recovery tools to be used.

Q5 *: Do you agree with the proposal that all EU CCPs may rely on alternative investments for the purpose of maintaining the SSITG?*

We are therefore not in favour of extending the list of assets eligible for investment of the SSITG compared to the first tranche of SITG.

[1] https://www.isda.org/2021/05/28/partial-tear-up-and-other-position-allocation-tools/

Q6 *: Do you agree that this list of alternative investments shall be specified in the draft RTS?*

We are therefore not in favour of extending the list of assets eligible for investment of the SSITG compared to the first tranche of SITG.

Q7 *: Do you agree with the proposed list of additional investments for the purpose of maintaining the additional amount of pre-funded dedicated own resources under Article 9(14)? If not, please explain why? If yes, is there any type of asset that you would like to add to or remove from the list?*

We believe that ESMA's proposal of allowing the same assets that the CCP accepts as collateral has two shortcomings:

Lists of eligible collateral can be very different between CCPs, depending on whether these CCPs have the ability to access central bank liquidity and the asset classes cleared, for instance if posted collateral can be netted against cleared positions.

Some CCPs have for good reasons very strict lists of eligible collateral, for instance because they need to be able to convert these assets into cash on short notice. Under no circumstance we would want these CCPs to be incentivised to extend the list of eligible collateral because their own investments are linked to this list.

We are therefore not in favour of extending the list of assets eligible for investment of the SSITG compared to the first tranche of SITG.

In any case, the CCP should apply the same haircuts to the assets that SSITG is invested in as it would apply for collateral. I.e. the CCP would invest more than the amount of the SITG in order to be sure it will receive back the full SSITG (within the confidence interval of the haircut calculations).

Q8 *: Do you agree with the proposed procedure for triggering specified recovery measures where all or part of the CCP's pre-funded dedicated own resources allocated to cover SSITG are not readily available for CCPs? If not, please explain why?*

We agree with the proposed principle in general.

Before the CCP however skips the SSITG level in the waterfall and proceed to the next layer, the following avenues should be explored:

- The CCP could use any cash reserves or liquidity resources above cover 2 to cover the shortfall.
- For NDL scenarios, where the first tranche of SITG is not used, the CCP can temporarily sell the more liquid assets of the first draft of SITG.
- The CCP pays for the loss initially out of its equity (which is invested in liquid assets), even if this means that the equity falls temporarily under its minimum capital requirements.

Q9 *: Do you agree with ESMA's proposed procedure for the compensation of non-defaulting clearing members? If not, please explain why?*

We do overall agree with ESMA's proposed procedure for the compensation of non- defaulting clearing members.

We however note that one month for liquidating assets which are so liquid that they are eligible collateral of the CCP feels overly long, even as a maximum.

We understand the use of recovery tool as a short-term stopgap until the CCP has liquidated their investments and can't see a scenario in which this can take longer than a month or even 6 months.

We welcome the clarification that the amounts due to the non-defaulting clearing members shall not be impacted by the actual proceeds of the sale of the assets but note that the consultation does not account for how a CCP might cover the shortfall. ESMA should consider whether the investments should be subject to a haircut to mitigate this risk – consistent with the treatment of such assets when they're posted by members as collateral.

Q10 *: Do you have access to different data and analysis that would contradict ESMA's conclusion that no further adjustment of the SSITG level based on competitiveness consideration is needed?*

We agree with ESMA's analysis and conclusion that no further adjustment of the SSITG level based on competitiveness consideration is needed.

We also note that the UK is planning to implement similar rules. Several Asian CCPs have either already a SSITG or a first tranche of SITG that is larger than the requirements under EMIR and CCPRRR for the first and second tranche of SITG. FIA and ISDA members will continue advocating for SSITG in other jurisdictions.

The resilience of the EU clearing infrastructure should take priority over any short-term concerns about the competitive impact of CCP SSITG. Maintaining resilience is critical to ensuring that the EU market remains attractive to participants. We strongly question whether a discussion on SSITG levels of 15% or 25% will have a material impact on the competitiveness of the EU CCPs, and as such the focus should be on the objective of this SSITG to continuously align CCP's risk management incentives throughout the CCP's waterfall.

Q11 *: Do you have any additional data that you may share in order to assess the impact of this requirement on the EU CCPs' competitiveness?*

N/A

Q12 *: Do you identify other benefits and costs not mentioned above associated to the proposed approach under each specified aspect of the methodology?*

N/A

Q13 *: If you advocated for a different approach, how would it impact this section on the impact assessment? Please provide details.*

N/A

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.

Our mission: To support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 countries. These members comprise 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 website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.