Perspective: CCP Clearing Models – May 11th, 2022

Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 250 market-infrastructures, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%). with everything from local entities in emerging markets to groups based in major financial centres. Collectively, member exchanges are home to nearly 53,000 listed companies, and the market capitalisation of these entities is over $95 trillion, while the 50 distinct CCP clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up $1 trillion of resources to back their risk positions.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair, and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise financial stability, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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CCP clearing models – feedback and important considerations for non-intermediated clearing models

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The WFE appreciates the opportunity to share feedback and set out important considerations when contemplating different types of CCP clearing models. As generally understood, the most commonly employed central clearing model is where a clearing member facilitates access and provides numerous operational and risk services, including financial performance guarantees to the CCP, both for itself as well as for their customers – ie, individual participants, also referred to as *end-users* (an 'intermediated clearing model' or **ICM**). Conversely, in a direct clearing model, each participant is a direct participant of the CCP, thereby assuming the financial performance responsibilities (of their exposures); and therefore, they must demonstrate that they have the requisite capabilities to do so, as well as satisfy any applicable regulatory obligations inherent in being a direct clearing member of a CCP (a 'non-intermediated clearing model' or **NICM**).

It is important to note that while both clearing models have existed for many years, it is generally accepted that intermediated clearing is the most widely accepted and utilised model despite any formal guidance to the otherwise. And while we recognize that there are certain CCPs that offer a combination of the models, it is however subject to strict standards that apply irrespective of the model and to participants that are highly sophisticated and demonstrate requisite of the CCP (e.g., financial, risk management, operational).

Our feedback is motivated by recent proposals (and a request for public comment by the CFTC)[1], nevertheless it is applicable to any discussion and consideration for and among different types of clearing models. In that context, our feedback seeks to ensure that any clearing model adheres to internationally accepted principles for centrally cleared markets, particularly fundamental risk management practices for CCPs, and that all interested stakeholders best understand the risk and regulatory framework that applies.

The WFE has been actively engaged in global reforms and regulatory/industry initiatives that took place following the Great Financial Crisis of 2008 (**GFC**). Many of these reforms and initiatives were designed and implemented with the ICM in mind, where the clearing member performs critical functions to a centrally cleared market, specifically regarding risk management, in the interests of resiliency and financial stability of the CCP and its participants and the stability of the broader financial system. Therefore, as other types of clearing models are contemplated, or indeed where they gain a more material presence, there must be a careful and comprehensive assessment of how such models demonstrate adherence to, among other considerations, the applicable guidance issued by international standard setters (ie, CPMI-IOSCO, FSB, BCBS) and implemented in their respective jurisdictions.

[1] https://www.cftc.gov/PressRoom/PressReleases/8499-22

EXECUTIVE SUMMARY

The WFE has long advocated for principles-based regulation that is focused on outcomes rather than prescriptive regulation. Against that background, **we believe that the *Principles for financial market infrastructures* (first published by CPMI-IOSCO in 2012, herein referred to as the PFMIs, and the related policy documents)[2] are an appropriate framework to perform a comprehensive assessment of any clearing model employed by a CCP to ensure that it meets globally agreed objectives to strengthen core financial infrastructures and markets**.[3]

The PFMIs are recognised as setting out industry best practices in risk management and as such, have been implemented locally by jurisdictions across the globe including the CFTC (as described in Part 39, for example). It is worth noting that all WFE member CCPs already perform such assessments – inclusive of public qualitative and quantitative disclosures – to demonstrate their adherence to the PFMIs and are further subject to extensive review and assessment the CCP's local primary regulatory. This also forms the basis for regular engagement with other key stakeholders, including, but not limited to, clearing members, their customers and end-users, and, where relevant, international agencies. The performance of such reviews and technical assessment(s) are essential to identify potential shortcomings and areas for enhancements to mitigate systemic risk (regardless of the clearing model employed) and is designed to support broader financial stability.

CCP Risk Management – PFMI Assessment

The PFMIs provide an overview of specific risks faced by CCPs, outlined as, legal, credit, liquidity, general business, customer, investment, and operational risks, among others. Within this section, we have utilised the PFMIs to structure our feedback and set out important considerations on the clearing model proposed by FTX US Derivatives (FTX) (ie, offering direct clearing of retail and other participants for margined derivatives products) and informed by materials that have been made publicly available. Note that we have focused only on certain risk management topics, however a full assessment against the PFMIs may reveal other high priority considerations.

For clarity, our comments are provided with the intention of motivating constructive and reasoned discussions on different types of clearing models to ensure common and agreed objectives are reached in a consistent and harmonised manner as set out by the G20 following the GFC. It is our initial conclusion that the direct clearing model proposed by FTX does not sufficiently demonstrate adherence to the PFMIs at this time.

General Organisation

1. <u>Governance (Principle 2)</u>: The FTX materials should provide more information regarding the governance arrangements that will be established, the remit of such governance arrangements, or details on whether the Board will be directly responsible and accountable for the establishment and effectiveness of the risk-management framework. The PFMIs (including the Further Guidance on the

[2] CPMI-IOSCO Principles for Financial Market Infrastructures, https://www.bis.org/cpmi/info_pfmi.htm
[3] Co-chairs' summary note for the CPSS-IOSCO Principles for financial market infrastructures, April 2012, https://www.bis.org/cpmi/publ/d101e.pdf

PFMI)[4] establish key considerations and guidance on governance arrangements that do not appear to have been considered comprehensively or implemented at this stage, nor does there appear to have been an evaluation of whether risk management proposals have been subject to any assessment by and discussion among all relevant stakeholders.

Specifically, the PFMI Key Considerations on governance require the CCP's risk framework to promote the stability of the broader financial system. **Provided the significance and systemic risk relevance of the FTX proposal, we believe further analysis on how the proposed risk framework meets such PFMI Key Considerations is required to ensure that this objective is demonstrated and that risk management incentives are not undermined.**

2. <u>Framework for the comprehensive management of risks (Principle 3)</u>: The FTX materials should provide more information regarding its approach to establishing a comprehensive framework (and described in the Key Considerations) for managing the risks for which it is exposed and of specific focus, the identification of risks, Incentives for participants to manage risks, interdependencies, and recovery and orderly wind-down planning. **These crucial risk management incentives for participants have enabled CCPs to successfully navigate past market stresses and events, therefore it is of critical importance that the FTX proposed risk framework be enhanced.**

Credit and Liquidity Risk Management

3. <u>Credit Risk (Principle 4)</u>: The FTX materials on the proposed NICM framework should further describe how its approach to adhering to the corresponding PFMI Key Considerations, particularly to its participants (including related expectations established in Principles 3 and 18). The failure to meet these Principles and corresponding Key Considerations, comprehensively, will result in shortcomings in the ability to manage credit risk, as exemplified in the following examples:

    a. <u>*Lack of membership criteria, risk-based participation requirements and risk monitoring*</u>. The FTX materials suggest that such practices – such as, capital and risk-based requirements – are less relevant (even stating that they are not relevant) resulting in what appears to be no financial/participation requirements nor monitoring of clearing member health (eg, capital wherewithal, credit quality) beyond funded collateral. Such practices are important to ensure all participants are incentivised to effectively manage their risk-taking (eg, as risk-taking increases, capital should also increase). **Such an approach fails to recognise the fundamental importance of these practices and how their absence stands to impact other forms of credit risk, other types of risks faced in a cleared market, and broader systemic stability.**

    b. <u>*Adoption of the 'extreme but plausible' standard for stress testing*</u>. The FTX materials do not provide sufficient information on the approach to stress testing for sizing resources to manage a default (ie, guaranty fund) nor indicate that 'extreme but plausible' historical and hypothetical scenarios have been contemplated or incorporated when measuring potential individual exposures or aggregate exposure for the CCP.

[4] CPMI-IOSCO Resilience of central counterparties (CCPs): Further guidance on the PFMI, July 2017, https://www.bis.org/cpmi/publ/d163.pdf

Specifically, the FTX materials state that increasing the assumed number of participant defaults is inherently extreme and therein decreases its plausibility. However, such thought pattern is not equivalent current approaches and practices (eg, extreme but plausible market conditions in stress testing). We believe that a more fulsome analysis on this approach is of critical importance to ensure that the totality of financial resources is sufficient.

Further, we consider that, given the intended membership structure and stated characteristics of its clearing members (specifically noted as being individual retail participants), it will be necessary to consider the increased likelihood of a significant number of clearing members defaulting simultaneously when determining if the resources of the guaranty fund are sufficient. Such consideration is important to better understand the potential impact of extreme but plausible market stresses and/or events which may quickly exceed intended coverage of the guaranty fund as currently described in the FTX materials.[5]

c. *Comprehensiveness of the method to determine sufficiency of the guaranty fund size*. The FTX materials assert that a capped amount of USD $250M shall always be sufficient; however, as noted above, it does not appear to contemplate the potential for increased *aggregate* exposure and susceptibility to market stresses and/or events as well as clearing member defaults due to lack of other credit risk mitigants that otherwise would act to reduce not only the frequency and impact of a default(s) but which – when present – create significant incentives for a clearing member to take preventive and reactive measures to not default in the first place.

Further, the proposed coverage methodology refers to coverage of up to three clearing member defaults. However, as each participant is its own clearing member, the coverage could also be described as only for up to three individual participant accounts. This coverage methodology is not comparable to the "Cover 2 standard" applied in an intermediated clearing model which commonly, in practice, provide coverage for hundreds, if not thousands of individual participant accounts, while also having the benefit of additional credit risk mitigants not present in this proposed NICM framework. We believe that a more comprehensive approach to assessing the sufficiency of the approach as well as its coverage is warranted, particularly given the unique features of the model and features proposed by FTX.

Furthermore, we consider that reverse stress testing exercises and dynamic sensitivity analysis would provide meaningful indications on the comprehensiveness of the approach ensuring the sufficiency of the guaranty fund methodology (including the approach to stress testing that informs such sufficiency).

4. Margin (Principle 6): The FTX materials should provide more information on the calibration of initial margin which, among other considerations, presents challenges for clearing members to manage their exposures and as such take proactive risk mitigating measures (eg, particularly in reaction to unpredicted market volatility). Furthermore, the proposed margining practice, is likely to increase the

[5] As currently proposed, the FTX proposal is inherently likely to experience significantly more clearing member defaults as the default of any individual participant will be managed by FTX directly. This eventuality is further exacerbated provided that the intended clearing members are likely to be less sophisticated participants that, under the proposed model, will have significantly less oversight and risk management standards applied (eg, credit risk monitoring, capital requirements).

risk of potentially further destabilizing measures, such as auto/forced liquidations and/or tear-ups, which may have the eventuality of (numerous and potentially frequent) clearing member default(s) on such obligations absent features and mechanisms that may otherwise exist.

Default Management

5. <u>Participant-default rules and procedures (Principle 13)</u>: The FTX materials describe the approach to default management and state that is leads to better outcomes for their clearing participant and the broader market. However, such conclusions appear to be pre-mature and made without a holistic and comprehensive analysis on the proposed approach which risks increasing systemic risk not only to the CCP but also the broader market if not properly understood or managed. **Given the extensive industry and regulatory focus, existing guidance, and current initiatives regarding default management, we believe that a more holistic and comprehensive analysis and approach is warranted.** We consider that such analysis together with industry and regulatory engagement would provide meaningful indications on whether these approaches are appropriate.

   a. *<u>Material reliance on Backstop Liquidity Providers (BLP)</u>*. The FTX materials should provide more information on the role of BLPs to, among other considerations, demonstrate their abilities and appropriateness to provide such critical functions to the CCP. The FTX materials describe the role of BLPs, stating that there is ex-ante contractual agreement to liquidate positions in the event that they were not able to be liquidated on the central limit order book. We consider that this suggests a scenario where such positions are illiquid and would require substantial premium to liquidate and may lead to material uncertainty and unpredictability for market participants at a time that would be considerably volatile. To that end, consistent with our remarks above, we query if the auto-liquidation mechanism (regardless if through the central limit order book or through the BLP) would always be a 'best practice' given that it not only creates uncertainty, it does not enable clearing members to pro-actively remedy any such scenarios to mitigate what could be material impact to their own risk management practices and exposures (at FTX, but also across other positions, etc.)[6].

      Further, it should be contemplated that any incoming positions to a BLP are likely to be already under- / uncollateralised (given the scenario that the FTX liquidation measures have not been successful), therefore careful consideration is needed and should be viewed holistically and comprehensively as part of the CCPs default management plan (inclusive of recovery measures).

      It is not clear what incentives and obligations exist for a BLP to liquidate any such positions, particularly where they were not deemed liquid enough to have been liquidated by FTX directly, and what costs may be associated to do so (ie, exposure to the guaranty fund, BLP retainer fees (paid by whom)) and what actions may be taken prior to and in the event where such resources have been exhausted (no mention of replenishment). Furthermore, the FTX materials suggest that the failure of a BLP to perform its stated role would expose participants that are in good standing (ie, sufficient margin on deposit) to significant risk as the proposed rules allow FTX to

[6] As currently proposed, the FTX proposal is inherently likely to cascades of liquidations and exacerbate market moves during stress markets that may also lead to participants having unhedged exposures (with no mechanism to understand ex-ante such eventuality).

apply partial tear-up(s) as a first line of defence (eg, prior to utilising the guaranty fund, BLPs, and potentially, even liquidation via the central limit order book).[7]

Regarding such recovery measures (eg, forced allocation, partial tear-ups), there has been extensive industry and regulatory discussions including guidance on such measures. We consider that any such measures should be assessed comprehensively, with specific focus to any differences in their application and resultant impact on incentives among impacted stakeholders.

b. *Suitability of and criteria for a BLP.* It is already current practice for CCPs to secure liquidity provider arrangements, eg, to engage market participants and liquidation agents to supplement default management practices as may be needed. For any party appointed to such role, qualitative and quantitative criteria must be established, tested, and routinely monitored to ensure that such arrangements can be relied upon in not only for a particular clearing member default event(s) but also in times of extreme but plausible market scenarios and events where, for example, liquidation costs and liquidity itself would be expected to be under material pressures. The described practices exist already and are common to those performed by CCPs today, which are further subject to 'fire drills, to ensure that such parties can be relied upon in periods of market stresses and events.

CCPs have carefully designed their risk and default management frameworks, including the financial resources that make up its default waterfall, to support incentives for market participants to effectively manage their risks, as has been demonstrated historically and in response to recent unprecedented market stress and events. We would like to reinforce that, as a principle matter, the viability of a CCP is not based only on the quantum of financial resources available in the event of a default(s); rather, and more significantly, risk incentives for participants to effectively manage their risks as well as the ability for the CCP to successfully apply default management procedures, which have been carefully calibrated by CCPs to align incentives to reduce exposure at the CCP, thereby reducing potential reliance on, and exposure to, available financial resources.

Conclusions

The WFE appreciates the opportunity to engage on these critical topics and would be happy to expand on any of the provided feedback and points of consideration. We wish to reinforce that while our feedback is motivated by recent proposals, it would be equally applicable to any discussion concerning different types of clearing models. In that context, our feedback seeks to ensure that any clearing model adheres to internationally accepted principles (ie, the PFMIs) for centrally cleared markets.

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[7] As currently proposed, the failure of the BLP to liquidate a clearing member's portfolio would increase the losses to FTX and prolong the time in which the CCP does not maintain a matched book.