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Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties

CFA Institute is pleased to comment on the International Organization of Securities Commissions' (IOSCO) and the Bank for International Settlements' (BIS) consultative report "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties" (the "Report").

CFA Institute, through its members' experience in international markets and different investment disciplines, represents the interests of investors and investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide. CFA Institute promotes fair, open, and transparent global capital markets, and advocates for investors' protection.

General Comments

The Report has been prepared by a working group jointly established by the Committee on payments and settlement Systems (CPSS) and the Technical Committee of IOSCO. It offers guidance on the 2004 CPSS-IOSCO Recommendations for Central Counterparties. More specifically it puts forward tailored guidance for 11 of the 15 recommendations, explicitly:

- Legal risk
- Participation requirements
- Measurement and management of credit exposures
- Margin requirements
- Financial resources
- Default procedures
- Operational risk
- Efficiency

- Governance
- Transparency
- Regulation and oversight

OTC derivatives typically are bilateral contracts between advanced users of financial products. They play an important role in that they make management of financial risk possible, facilitate price discovery and make for efficient markets. They have, however, also spread risks throughout the economy with negative results in some cases. Problems surrounding OTC market include unsatisfactory transparency and price discovery, excessive speculation and disproportionate leverage.

CFA Institute is of the opinion that all standardized and standardizable OTC contracts should be subject to central clearance. In a CFA survey conducted in the US in October 2009, 78 per cent of the respondents expressed their support for this idea.[1]

Although central clearing concentrates counterparty risk in an entity specifically chartered to handle it, it does not solve all problems associated with OTC trading. More notably central clearing does not provide price discovery, transparency or regulatory oversight. Consequently, CFA Institute promotes provisions requiring all standardized OTC derivatives to be traded on regulated exchanges. This position is supported by 68 per cent of the respondents in our October 2009 member poll.

Overall, CFA Institute finds the guidance set out in the Report plausible. Our comments to each recommendation are set out here below.

Yours faithfully,

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[1] The survey results are based on the responses of 755 CFA Institute members based in the United States. The results are available at http://www.cfainstitute.org/Survey/us_iwg_poll_report.pdf

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CFA Institute develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

Specific Comments

Recommendation 1: Legal risk

A CCP should have a well founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

In the OTC derivatives market, there are industry standards and market protocols that apply to CCPs clearing these products. It is important for OTC derivatives CCPs to be transparent about the role of such standards and protocols in their rules, procedures and contracts.

We agree that a well founded, transparent and enforceable legal framework is of paramount importance to the effective operation of a CCP. Given the systemic risks associated with the OTC derivatives market, we strongly suggest that agreements concerning OTC and conventional instruments be reviewed for robustness, for example in respect to performance with margin and capital requirements and the consequences for not meeting those obligations at the appointed time.

Recommendation 2: Participation requirements

A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access.

Where non-regulated entities are admitted to participate in an OTC derivatives CCP, it is important that the risks should be appropriately mitigated by its participation requirements and other appropriate measures.

If an OTC derivatives CCP uses procedures which introduce specific roles for its participants in the default procedures, it may need to consider if and to what extent additional participation requirements are necessary in order to ensure that the participants are able to perform their roles as expected.

CFA Institute supports the guidance regarding non-regulated entities as set out on page 12 of the report. Examples of non-regulated entities which may be admitted to participate in an OTC derivatives CCP are hedge funds and large corporations. The guidance suggests the following requirements: *requiring the entity to post additional upfront collateral with the CCP; establishing requirements for the entity to designate staff responsible for overseeing CCP-cleared business; requiring the entity to submit certain reports on its exposures to unaffiliated trading markets or other OTC business; requiring an external certification or audit of robustness of the entity's operational capacity prior to admission and on an ongoing basis; employing risk management tools to limit the CCP's exposure to the entity; and/or introducing any other requirements to ensure that the entity meets relevant fit and proper standards.*

Recommendation 3: Measurement and management of credit exposures

A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements, other risk control mechanisms or a combination of both, a CCP should limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

Certain risks of OTC derivatives products may only manifest themselves during stressed market conditions and may be amplified due to a correlation among risk factors. Consequently, an OTC derivatives CCP should ensure that it has the appropriate expertise to understand fully the characteristics of its cleared products and to effectively measure and manage credit exposures.

For some OTC derivatives products, a CCP's ability to measure its exposures may be affected by the lack of a continuous liquid market. It is important for an OTC derivatives CCP to use pricing data that it considers to be reliable, especially in times of market stress. It should review its pricing sources on an ongoing basis. Alternative pricing tools that are used when market prices become temporarily unavailable should be thoroughly tested, be understood by all participants and generate results in a timely manner.

We support guidance on measurement and management of credit exposure. In this context, it is vital to bear in mind that nearly all financial instruments, OTC derivatives included, are to some extent related to the same fundamental macroeconomic factors. This was an important lesson learned in the recent financial crisis. Consequently, to fully measure the credit exposure of a CCP it is essential to have a comprehensive picture and to fully understand interrelationships between the OTC derivatives being cleared and those fundamental factors and in particular how they will perform under extreme but possible circumstances.

Recommendation 4: Margin requirements

If a CCP relies on margin requirements to limit its credit exposures to participants, those requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.

Given the potential difficulty in measuring exposures, it is important that the margin methodology, and any material revisions, should be reviewed periodically by a qualified, independent internal group or third party and through rigorous backtesting and stress testing of margin requirements.

The bilateral nature of OTC derivatives transactions and the increased potential for customisation of contracts typically results in reduced fungibility and trading liquidity than that in listed markets. This aspect needs to be considered when an OTC derivatives CCP establishes margin levels that should be commensurate with the risks of each cleared product, taking into account the time it may need to hedge its exposures or liquidate positions in the event of a participant's default.

As correlations among complex financial products could become unstable in unanticipated ways in times of market stress, continual review of product correlations is particularly important for an OTC derivatives CCP that uses portfolio margining across different products. Clear disclosure to its participants about the scale of portfolio margining and the method used is highly beneficial.

The tailored guidance on margin requirements as set out in the Report is reasonable. From an investor point of view, it is important that the margin requirements be set high enough that it adequately ensure that trades clear and settle as expected while at the same time not so high that it is too costly for counterparties to engage in prudent risk management. Moreover, it should not create a false impression of protection for investors, regulators, counterparties, or the general public. To ensure accurate investor protection and robustness of the system, it is important that there are periodical revisions of the margin methodology. These reviews should be conducted by a qualified, independent internal group or an independent third party. A further consideration is the tendency of correlations between assets to trend to 'one' in times of financial crisis.

Recommendation 5: Financial resources

A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.

The size and adequacy of the financial resources available to cover losses to an OTC derivatives CCP should capture all relevant characteristics of the products that it clears. Given the potential difficulty in defining what constitutes "extreme but plausible market conditions" for particular OTC derivatives markets, it is important for an OTC derivatives CCP to have clear and up-to-date scenarios for the stressed market conditions used in its routine stress testing.

When an OTC derivatives CCP defines or changes the way each participant contributes to its financial resources and the way those resources are used, it needs to consider the potential impact on the incentives of participants to manage their own risk. It should also take into consideration that the scale and risk of participants' activities may not be homogeneous, including the fact that not all participants may clear all products cleared by the CCP.

The requirement to have sufficient financial resources to withstand the default of the participant to which the CCP has the largest exposure is somewhat blunt. Firstly, this level is likely to be dynamic and very volatile since it is measured by the exposure to one single participant at one moment in time. The minimum requirement will change drastically as the largest participant changes its exposure or if it leaves completely.

Secondly under extreme but plausible circumstance, more than one participant may very well default within a short period of time. It might therefore be reasonable to consider a more sophisticated way of defining the required minimum level of financial resources. Such a definition should take into account the CCPs' total exposure to a broad downturn in financial markets and the economy as a whole.

Recommendation 6: Default procedures

A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available.

In the event of a participant's default, it may be difficult to close out or hedge exposures to the defaulting participant in a timely and orderly manner. To address such a scenario, an OTC derivatives CCP may need to consider having clearly defined arrangements that oblige surviving participants to perform certain roles in the default procedures, such as participation in an auction or allocation of the defaulting participant's portfolio. For certain OTC derivatives products that require considerable trading expertise, a CCP may need to make ex ante arrangements to ensure that it has sufficient trading staff with proper risk management expertise.

In managing the portfolio of a defaulting participant, an OTC derivatives CCP may need to enter into trades that hedge the individual positions within the portfolio or enter into a macro-hedge that attempts to manage the risk of an entire portfolio. In such a situation, a CCP may need to consider its ability and the timeframe required to obtain individual hedges; the cost of obtaining those hedges; and its ability and the associated cost to actively manage the associated risks (including basis risk) of the hedging strategy.

A CCP should clearly state its policies, procedures and any constraints relating to the segregation of positions and collateral between its participants and their customers; provide its participants with sufficient information on the level of segregation that is achieved in the CCP's operation; and endeavour to transfer the positions and collateral of customers of a defaulting participant.

Default procedures are another area of importance to investor protection. Protection against counterparty risk is a main argument for using CCPs. To deliver this it is fundamental that the CCP have robust default procedures to ensure it can continue to meet its obligations in the case one or more participants default. The guidance set out in the report constitutes means to achieve this. CCPs should be as transparent as possible about default procedures so that investors can judge how effective such procedures are.

Recommendation 8: Operational risk

A CCP should identify sources of operational risk and minimise them through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfilment of a CCP's obligations.

As OTC derivatives CCPs are likely to rely on information or services from other market infrastructures or service providers, operational risk associated with such links should be understood and managed by strong arrangements for the selection and ongoing monitoring of the providers of services. A CCP's staff responsible for such selection and monitoring should have the necessary expertise.

If an OTC derivatives CCP establishes links with multiple venues to accept trades for clearing or starts to clear global OTC derivatives products, potential impacts on its capacity and scalability should be assessed and regularly reviewed.

CFA Institute supports the operational risk requirements and the proposed accompanying guidance as set out in the Report.

Recommendation 12: Efficiency

While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.

In OTC derivatives markets, where trading could occur over multiple venues, it is important for a CCP to conduct a thorough and regular analysis of risks, costs and benefits from accepting and clearing trades that are executed or processed at different venues.

As the scope of products that an OTC derivatives CCP clears may have important implications for how cost-effective it is for its participants (including indirect participants) to clear OTC derivatives products, an OTC derivatives CCP should have in place mechanisms to analyse the cost and operational reliability of clearing an OTC derivatives product.

We support the efficiency requirements and the proposed accompanying guidance as set out in the Report.

Recommendation 13: Governance

Governance arrangements for a CCP should be clear and transparent to fulfil public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.

Participants in OTC derivatives CCPs are likely to be less homogeneous with greater direct or indirect participation by buy-side firms and non-domestic institutions. Governance arrangements for a CCP should give due consideration to the interests of different types of its participants, to broader stakeholders with direct and indirect interdependencies with the CCP and to the CCP's unique role in the market.

A CCP may need to take independent emergency actions in response to circumstances beyond its control. As such actions may have unintended consequences, a CCP should have a strong governance process that includes clear policies and procedures for identifying and managing contingencies, engaging its participants and other stakeholders, and considering the impact of its actions on the stability of the market more broadly. The CCP should have a well established process for effective and timely decision-making and communication.

Governance arrangements for a CCP should ensure that its decision to clear new products or accept new types of participants takes into account a wide range of issues, including risk management, legal soundness and transparency.

As participants in the OTC market, CCPs are expected to adhere to reliable industry standards and market protocols or act in a manner that does not conflict with such terms. Market governance arrangements should evolve in such a way that reflects the role of CCPs.

CFA Institute supports the governance requirements and the proposed accompanying guidance as set out in the Report. We do however believe that there should be clearer direct guidance on how to detect and manage potential conflicts of interests. This is of special importance to CCPs considering the variety of stakeholders, including public interest.

Recommendation 14: Transparency

A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

An OTC derivatives CCP should contribute to enhancing market transparency by making market data available to relevant authorities and the public in line with their respective information needs. Common standards for data representation and delivery are important for proper aggregation and consistent analysis of the data.

Being a central infrastructure, CCPs play a critical role in financial markets. Their central position makes them important to overall efficiency of the market. They are well positioned to increase market transparency. We therefore support requirements for a CCP to make available, in a timely manner, market data appropriate to the market it serves. Timely should mean daily. The data should be available not only to regulators but to investors and the public as a whole.

Recommendation 15: Regulation and oversight

A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and an international context, central banks and securities regulators should cooperate with each other and with other relevant authorities.

Common reporting should be promoted by relevant authorities where more than one CCP provides its services across jurisdictions and/or where there are several relevant authorities from more than one jurisdiction involved in regulation and oversight of such CCPs.

CCPs should be subject to adequate regulation and supervision. CFA Institute welcomes common reporting as suggested in the guidance. We also support cooperation and exchange of information between supervisors. Furthermore, the regulatory approach towards CCPs should be consistent across jurisdictions so as to reduce the potential for CCPs competing on the basis of lower costs or reduced requirements. This is particularly important for a business like this whose role it is to concentrate risks in a manageable manner.

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