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January 18, 2022

CPMI and IOSCO Discussion Paper on Client Clearing: Access and Portability

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TO: Derivatives Markets Advisory Committee RE: CPMI and IOSCO Discussion Paper on Client Clearing: Access and Portability

On 29 November 2021, the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) published[1] a discussion paper (DP) on access to central clearing and portability.[2] CPMI and IOSCO ("CPMI-IOSCO") are accepting feedback on the DP by 7 February 2022 (extended from 24 January 2022). Please contact me at giles.swan@ici.org if you would like to provide input into ICI Global's response. A draft of ICI Global's response to the DP will be circulated for member input. The DP is summarised below.

Background

CPMI-IOSCO have published the DP in order to:

- increase their understanding of new access models to clearing and porting practices; and
- identify potential issues for possible follow-up work from the industry.

In the DP, CPMI-IOSCO highlight that firms which are not direct participants of a central counterparty (CCP) must rely on having their trades cleared by an intermediary - a client clearing service provider (CCSP) - which is a direct participant of the CCP. Through the DP, CPMI-IOSCO are seeking to:

- develop knowledge and understanding regarding new access models by which entities that historically have participated indirectly as "clients" could directly access CCP services;
- develop knowledge and understanding of current porting processes in place at CCPs;
- examine and analyse possible solutions to facilitate access and portability arrangements;
- consider in particular the potential benefits, risks and challenges that these new possible solutions may bring with respect to access[3], tiering[4] and portability;[5] and

- elicit comments and feedback from a broad range of interested stakeholders.

Discussion Paper

In the DP, CPMI-IOSCO note the importance of CCPs in the financial system and recall the 2009 G20 commitment to ensure that all standardised over-the-counter (OTC) derivatives contracts are cleared through CCPs. CPMI-IOSCO also recalls the findings of the Derivatives Assessment Team's (DAT)[6] analysis of the implementation of the G20 reforms which found that clearing services were provided by a relatively small number of bank-affiliated clearing firms.[7] Furthermore, CPMI-IOSCO highlight the importance of access to clearing for firms that are not direct clearing participants for the success of the G20 reforms.

Against the backdrop above, CPMI-IOSCO has decided to analyse whether and to what extent concentration in client clearing creates issues of concern specifically in relation to client access. The CPMI-IOSCO Steering Group mandated a Policy Steering Group (PSG) to undertake analysis into this issue. During 2019, the PSG held an industry workshop and undertook a survey and during 2020 carried out follow-up interviews with stakeholders.

Clearing Access

CPMI-IOSCO recall the DAT's findings that some categories of client have a lower degree of access to central clearing. The DAT found that lower turnover clients and clients with directional portfolios are likely to have insufficient transaction flow to be profitable for many CCSPs. The DAT also found that minimum clearing fees had increased between 2012-2017 to cover onboarding, know-your-client and regulatory capital costs incurred by CCSPs. The DAT concluded that potential issues relating to client access to central clearing and client incentives to clear may be exacerbated by the concentration in CCSPs. CPMI-IOSCO note that some firms have reported only being able to access clearing through a single CCSP. Furthermore, as backup arrangements are economically unviable or unavailable, such firms have expressed concern that they would not be ported successfully in the event of a CCSP default, which would leave them without clearing access.

Direct and Sponsored Access

CPMI-IOSCO note that new access models may provide solutions to some of the issues identified by the DAT, but the feasibility of these models remains unclear and issues on portability are still to be explored. CPMI-IOSCO highlight the objectives of alternative access models - such as direct access and sponsored access - to improve access to CCPs by some categories of client. CPMI-IOSCO note that such access models are mainly designed for larger clients - due their operational and liquidity requirements - rather than medium or small clients which are the entities facing the most difficulty in accessing clearing.

In the DP, CPMI-IOSCO highlight the following features, opportunities and challenges related to direct access and sponsored access models:

- the transfer of some responsibilities of traditional CCSPs to the buy-side, including contributing to the CCP's default or clearing fund;
- the potential to address existing client concentration issues by diversifying the risk profile of the direct clearing participation client base; and
- the potential to create new concentration risks if the number of CCSPs providing sponsored access remains limited.

CPMI-IOSCO highlight that buy-side entities are not able to become direct clearing participants themselves due to prohibitions on loss mutualisation.

CPMI-IOSCO note some reports of an increase in sponsored access, particularly for repo where there are stronger balance sheet incentives, but that overall take-up is limited. CPMI-IOSCO suggests this limited take-up might be attributed to the use of individually segregated margin-flow co-mingled account (ISOC) structures and the fact that direct clearing participants are only obliged to provide one form of individually segregated client account.

In the DP, CPMI-IOSCO notes that direct and sponsored access models are designed for certain types of large, sophisticated clients. Furthermore, that the complexity of access models, including risk management procedures and other licencing requirements, have the potential to be a barrier to the models' use, particularly for smaller clients. CPMI-IOSCO suggests that the offering of access models seems to be driven by client demand, so if this demand grows then new models will spring up to meet it. However, the demands of smaller clients may not have as much commercial influence as the demands of larger clients. Accordingly, new access models may not be a solution for increasing smaller clients' access, even with increased demand.

Porting

CPMI-IOSCO highlights the need to port or liquidate CCP client accounts in a short-time frame in the event of a CCSP's default. Furthermore, CPMI-IOSCO notes that forced liquidation - for instance if no CCSP agrees to port over the accounts - is an undesirable outcome for the client and the market generally.

In the DP, CPMI-IOSCO discusses potentially effective porting practices. The survey analysis and industry outreach undertaken by CPMI-IOSCO has identified the following two factors which appear to support successful porting:

- pre-emptively identifying potential alternative CCSPs; and
- account structures that facilitate fully margined client positions.

CPMI-IOSCO notes that 'game plans' are sometimes developed which identify potential alternative CCSPs (either identified by the CCP or by clients). Furthermore, some jurisdictions have legal frameworks that facilitate porting, subject to finding transferee CCSPs promptly. CPMI-IOSCO's survey analysis and industry outreach suggests there are a range of factors that determine the outcome of porting. In particular, product constraints, balance sheet availability and the low profitability of providing clearing services to certain clients limit the ability of many CCSPs to receive ported clients.

CPMI-IOSCO recalls that some account structures increase the chance that the account is fully margined - thereby facilitating more efficient porting. Furthermore, that accounts which are gross margined, but with mutualised risk, may also be simpler to port. Industry outreach by CPMI-IOSCO has identified that certain CCPs offering net margining may not be able to offer bulk porting due to jurisdictional requirements to receive client consent for porting. In the event that accounts can't be ported 'in bulk', CPMI-IOSCO concludes that the CCP would most certainly liquidate omnibus client accounts due to the difficulty of achieving consensus consent in the requisite time frame.

In the DP, CPMI-IOSCO notes that some CCPs permit clients to make direct payments and others may be able to rely on excess collateral maintained by clients in individually segregated accounts, both of which may extend the time available for porting (subject to jurisdictional regulatory constraints).

CPMI-IOSCO recalls the principles that have been established for the disclosures that financial market infrastructures (FMIs) should make to their participants and beyond.[8] In support of these principles, CPMI-IOSCO highlights that CCPs should consider the appropriate degree of communication and coordination before and during the porting process, including to clients and other CCPs in order to coordinate the porting of the defaulting CCPs' clients to a single CCSP when possible.[9] CPMI-IOSCO notes the limitations from a regulatory and commercial perspective of such coordination.

In the DP, CPMI-IOSCO contrasts industry perspectives on harmonising porting practices - CCPs do not see merit in harmonisation whereas clients and CCSPs consider that harmonisation could reduce complexity, cost and the likelihood of delay. CPMI-IOSCO notes that increased automation could increase the efficiency and effectiveness of porting arrangements as could standardised,[10] such as standardising the type, format and granularity of key data, file formats, templates and terminology. CPMI-IOSCO's survey analysis and industry outreach identified regulatory impediments, insolvency frameworks, collateral transfer, testing and transparency as important issues to consider when developing a porting protocol.

In the DP, CPMI-IOSCO notes that the PSG has identified the following six areas that it considers warrant further consideration by the industry in order to better facilitate porting:

- Alternate CCSPs: CCPs that plan to use backup CCSP arrangements should consider clearly outlining the circumstances in which an alternate CCSP should be in place, as well as considering incentives for CCSPs or clients to support the use of these arrangements and how conflicts that arise can be addressed.
- Game plans: CCPs may consider developing porting game plans, including: (i) creating a protocol to contact clients to the extent that consent is needed; and/or (ii) exploring when consent can be given contractually in advance, in order to facilitate porting.
- Communication and coordination: CCPs may consider: (i) taking steps to communicate and coordinate with each other in the event of a CCSP's default, before and during the porting process to the fullest extent possible, in accordance with applicable law; (ii) developing and expanding protocols that facilitate coordination in the event of a CCSP default, including sharing CCP, CCSP and client contact information. In the event that porting is unsuccessful, CCPs may consider coordinating the liquidation of client positions with other CCPs in order to reduce the negative consequences of bulk liquidation.
- Harmonisation: CCPs may consider developing templates of what can be automated and standardised in the porting process.
- Testing: CCPs should consider developing porting test exercises that go beyond basic operational testing via: (i) direct payments from clients to CCPs in an exercise; (ii) testing porting of one or more CCSPs defaulting at multiple CCPs to evaluate the ability of CCPs to coordinate; and (iii) incorporating stressed market conditions, capital limitations at CCSPs and compressed time frames in porting exercises.
- Transparency for clients: CCSPs may consider disclosing portability risks associated with different account structures in addition to the more typical disclosures currently made to clients about fellow customer risk and the risks of not being ported.

CPMI-IOSCO raises 31 questions covering the various topics raised in the DP.

Next Steps

CPMI-IOSCO are accepting feedback on the DP by 7 February 2022 (extended from 24 January 2022.) CPMI-IOSCO have indicated that they are seeking to identify potential issues for follow-up work, including increasing common understanding of new access models to clearing and effective ways to support successful porting in instances of CCP member default.

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endnotes

[1] Press Release: Call for comments on access to central clearing and portability, Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) , 29 November 2021, *available from* https://www.iosco.org/news/pdf/IOSCONEWS628.pdf

[2] A Discussion Paper on Client Clearing: Access and Portability, Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions, November 2021, *available from* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD691.pdf

[3] Principle 18: "An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access", Principles for Financial Market Infrastructures ("PFMI"), CPMI and IOSCO, April 2012, *available from* https://www.bis.org/cpmi/publ/d101a.pdf

[4] Principle 19: "An FMI should identify, monitor, and manage the material risks to the FMI arising from tiered participation arrangements", PFMI

[5] Principe 14: "A CCP should have rules and procedures that enable the segregation and portability of positions of a participant's customers and the collateral provided to the CCP with respect to those positions", PFMI

[6] Made up of the FSB and the other standard-setting bodies, including the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures, the Financial Stability Board and the International Organization of Securities Commissions.

[7] Incentives to centrally clear over-the-counter (OTC) derivatives A post-implementation evaluation of the effects of the G20 financial regulatory reforms - final report , 19 November 2018, Derivatives Assessment Team, *available from* https://www.fsb.org/wp-content/uploads/R191118-1-1.pdf

[8] Principle 23, PFMI addresses transparency by providing that "an FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks, fees, and other material costs they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed" and key consideration of Principle 14, PFMI addresses the disclosure of

"rules, policies, and procedures relating to the segregation and portability of a participant's customers' positions and related collateral…[as well as] any constraints, such as legal or operational constraints, that may impair [the CCP's] ability to segregate or port a participant's customers' positions and related collateral"

[9] *E.g.* through forums such as the Default Risk Management Working Group.

[10] CPMI-IOSCO raised suggestions for standardisation in a discussion paper on CCP default management actions, *available from* https://www.bis.org/cpmi/publ/d185.pdf