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Dear Sir/Madam:

Re: CBA[1] Response to CSA requirements and coordinated CSA - Bank of Canada guidance for clearing agencies operating in the Canadian market

The Canadian Bankers Association (CBA) welcomes the opportunity to provide comments on the Notice and Request for Comments published by the Canadian Securities Administrators (CSA) with respect to the proposed National Instrument 24-102 *Clearing Agency Requirements* and its companion policy, as well as the Bank of Canada's request for comments on *Risk Management*

[1] The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

Standards for Designated Financial Market Infrastructures (FMIs), within which supplementary guidance was developed jointly with l'Autorité des marchés financiers (Quebec), British Columbia Securities Commission and Ontario Securities Commission.

The CSA's National Instrument and the Bank of Canada's risk management standards for FMIs are heavily grounded in the Committee on Payment and Market Infrastructures (CPMI) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) Principles for Financial Market Infrastructures (PFMIs), an internationally-agreed set of standards, which will not be debated in this comment letter. Instead, we focus our comments on select principles where Canadian authorities have jointly proposed supplementary guidance for Canadian clearing agencies, or intend to do so in the case of ongoing policy matters, as well as on areas where CSA members propose additional requirements for recognized clearing agencies.

Chief amongst our recommendations are those relating to clearing agency recovery and resolution frameworks. We suggest that Canadian guidance relating to these frameworks be developed with urgency, particularly where its adoption may entail significant changes to the risk profile of Canadian FMIs. We then present considerations and provide recommendations for the eventual structure of recovery and resolution frameworks in Canada.

Comments are also provided concerning Canadian authorities' supplementary guidance on clearing agency "skin in the game"[2], disclosures and collateral, whereby we recommend that:

- skin in the game be a specific and quantifiable requirement tied to a clearing agency's risk exposures;
- additional clearing agency disclosure requirements, specifically as they relate to stress test methodologies and results, be considered; and,
- Canadian authorities prioritize legislative changes that facilitate the posting of cash collateral to Canadian FMIs.

In several of the above areas, our comments build upon industry work done by the International Swaps and Derivatives Association (ISDA) and other market participants.[3]

Finally, we provide broader comments on the Canadian regulatory framework for clearing agencies and propose that Canadian authorities:

- simplify and clarify their process for exempting foreign clearing agencies, through a series of jurisdiction-level comparability determinations; and,

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[2] For the purposes of this comment letter, a clearing agency's "skin in the game" refers to its contribution of own funds to loss allocation in a participant default.

[3] See for example ISDA, *CCP Loss Allocation at the End of the Waterfall,* http://www2.isda.org/attachment/NTc5Nw==/CCP_loss_allocation_waterfall_0807.pdf;
ISDA, *Principles for CCP Recovery,* http://www2.isda.org/attachment/NzExMw==/Principles%20for%20CCP%20Recovery%20FINAL.pdf;
ISDA, *CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework*, http://www2.isda.org/attachment/NzE5OQ==/CCP%20Default%20Management%20recovery%20and%20continuity%2026-01-2015.pdf;
JP Morgan, *What is the Resolution Plan for CCPs*?;
BlackRock, *Central Counterparties and Too Big to Fail*; http://www.blackrock.com/corporate/en-lm/literature/whitepaper/viewpoint-ccp-tbtf-april-2014.pdf;
PIMCO, *Setting Global Standards for Central Counterparties*, https://canada.pimco.com/EN/Insights/Pages/Setting-Global-Standards-for-Central-Clearinghouses-.aspx.

- provide greater transparency regarding their supervision and oversight process with respect to Canadian clearing agencies.

Further details are provided below.

There is an imminent need for clearing agency recovery and resolution planning in Canada

A default or emergency situation at a clearing agency would undoubtedly give rise to financial stability and public interest considerations. For this and other reasons, we support Canadian authorities' guidance requiring that clearing agencies maintain an explicit framework for defaults and other emergency scenarios. We particularly echo the need for clearing agencies to adopt emergency policies which balance the interests of the FMI, its participants, and financial stability.

In line with forthcoming guidance, Canadian clearing agencies already maintain emergency frameworks today; yet, we believe that these remain incomplete until they fully encompass recovery and resolution considerations.

Loosely defined, recovery measures are those taken by a clearing agency to allocate uncovered losses or to re-establish critical functions, both of which could jeopardize its ability to serve members and the underlying market. Resolution occurs when recovery cannot be achieved and a clearing agency must terminate activities in the least disruptive way possible.

Acknowledging that the Bank of Canada and CSA have deferred the development of regulatory guidance pertaining to recovery or orderly wind-down plans, we stress the importance of prioritizing this work. Without further clarity on related frameworks, it becomes difficult for Canadian market participants to build a holistic view of their FMI risks and how these may change once new recovery and resolution regimes are in place.

Below, we outline important considerations and corresponding recommendations for Canadian clearing agencies' recovery and resolution plans. Our recommendations are targeted to help Canadian authorities' shape guidance for Canadian FMIs; however, we hope that international requirements would yield similar outcomes. To this end, we encourage Canadian authorities to consider these same issues when participating in international regulatory discussions.

Loss allocation to a clearing agency's participants should be clear, quantifiable and predictable

For Canadian financial institutions, participation in clearing agencies is unavoidable. As clearing agencies continue to capture market activity, through both clearing mandates and entrenched market practice, it also becomes nearly impossible for participants to fully reduce exposures to these infrastructures, even if a clearing agency's stability is questioned.

Consistent with the above, participation in several clearing agencies' loss management procedures would be imperative following the default of a large global institution. Such a scenario presents systemic risks as loss management actions taken by both Canadian and foreign clearing agencies (e.g. calls for additional resources from surviving members) – in tandem – can have significant destabilizing impacts.

A critical first step towards minimizing risks from clearing agency default management is to provide full clarity to members regarding default policies and procedures, up to the point of recovery or resolution. Full clarity is essential to promoting participants' preparedness for a possible default. In particular, clearing agencies' loss allocation frameworks, including the use of any recovery tools, should also be clearly documented with associated contingent losses that are limited and that can be fully quantified by members. Regulatory or management discretion to unilaterally impose additional losses on members, in times of crisis, should not exist. Finally, as is further described below, attempts to recover a clearing agency should be time-bound with a clear governance process for declaring an infrastructure's non-viability.

Canadian clearing agencies should face minimum requirements when developing recovery tools

Global clearing agencies continue to develop new recovery tools, while the topic of appropriate recovery design remains actively debated by ISDA members and other market participants. Drawing from these debates, we see it as unlikely that a single universal approach to clearing agency recovery will emerge.

Canadian clearing agencies will require flexibility to develop tools that are suited to their particular business and context. That being said, we believe that Canadian clearing agencies should adopt minimum requirements for acceptable recovery design. We provide early-stage suggestions for appropriate recovery planning below.

- Recovery tools should not jeopardize the netting status or capital treatment of cleared transactions.

Clearing offers important benefits through multilateral netting, which allows clearing participants to manage offsetting risks on balance sheet and in regulatory capital calculations. Recovery tools such as partial contract termination could have uncertain impacts on the treatment of CCP netting. We remain sceptical of these tools and encourage a high level of cross-jurisdiction due diligence regarding netting and other potential consequences before they are contemplated.[4]

- Non-defaulting members' initial margin should not be included as a recovery tool.

Initial margin is a defaulter-pays resource, receiving regulatory capital treatment that assumes its safety in a fellow member or clearing agency default. Including initial margin in a recovery toolkit would challenge the above assumptions and surely introduce new costs and risks.

- Recovery tools should apply across all member types and all member tiers.

Clearing agencies should consider the application of recovery tools to all participants – including indirect participants – trading a product class subject to losses, such as through the reduction of unpaid payment obligations (e.g. variation margin haircuts) and corresponding loss allocation to participants with out-of-the money positions. All participants draw benefits from central clearing and should be required to support the FMI in an emergency.

[4] See ISDA, *CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework*. A form of partial contract tear-up (i.e. termination) is seen as a potential tool for a clearing agency to return to a matched book, if its default auction has failed. Such an approach is preferred to the forced allocation of a defaulter's positions to surviving participants. ISDA's analysis to date suggests that partial contract tear-up could be structured without impacting accounting treatment to net cleared derivatives and regulatory capital treatment.

- The impact of recovery tools should be bounded.

A clearing agency's participants should not be subject to unlimited losses, as this is counter to sound risk management principles. Forced allocation of a defaulting member's contracts to surviving members, for example, could entail large losses and be damaging to financial stability.

There will be the need for an impartial resolution authority in Canada

The recovery of a clearing agency will not always be preferable to its resolution. If a clearing agency's risk management fails, such as through an unsuccessful default auction or other inability to return to a matched-book, complete contract tear-up may be the optimal scenario. Notably, where a CCP is structured into several self-contained service lines, the closure of one of these may preserve the broader infrastructure provider.

In Canada, the nomination of a pre-determined and independent resolution arbiter would be helpful in determining when a clearing agency has reached the point of non-viability. At such a point, the clearing agency's default management framework should cease to be applied and the entity resolved. Further, we believe that a clearing agency's default procedures should clearly set-out the time-frame for its recovery attempt, creating an implicit cap on potential market movements in cleared contracts and providing greater certainty to surviving members.

A resolution arbiter – likely from the regulatory sphere – would require in-depth knowledge of a clearing agency's operations and risk profile in order to determine when its activities should be resolved. We also encourage the involvement and notification of OSFI and CDIC in the decision to resolve a clearing agency, since they would have regulatory and resolution responsibility for a Canadian clearing agency's largest members.

Canadian clearing agencies should face risk-based and quantifiable requirements in relation to self-funded loss absorbing resources

In the previous section, we discuss recovery and resolution measures to be applied in default scenarios that go beyond the extreme, but are still plausible. In the normal course, a participant's pre-funded collateral would be expected to offset their own default. However, at a time when clearing agencies have shifted from a utility-like structure to more independent ownership, there are growing calls for incentives that ensure an appropriate level of clearing agency risk management is achieved. In addition, it is important to note that Canadian banks are members of a number of consolidated entities that house several clearing agencies or service lines and face significant risks if these consolidated entities do not have sufficient resources or if they are not legally structured in a way to mitigate contagion across clearing services.

Clearing agency "skin in the game" should be a quantifiable requirement

Skin in the game is an important tool for aligning the risk management interests of a clearing agency's owners and operators with those of FMI participants. Despite this important role, skin in the game currently varies widely across clearing agencies. We believe that Canadian regulatory requirements should be one catalyst for setting a common expectation across clearing providers.

As outlined in Part 4 of the proposed National Instrument, CSA members propose that a clearing agency's equity contribution to its loss waterfall "should be a reasonable proportion of the size of the default fund". This guidance by Canadian authorities lacks specificity and we encourage a more stringent requirement. The preferred option would tie clearing agency "skin in the game" to specific risk-based measures, for example, a fixed percentage of a clearing agency's tail risk (i.e. default fund). Further work will be required to determine a more appropriate level of CCP skin in the game. We expect and remain open to further local and international discussions on this topic.

Clearing agency capital requirements should cover a broad range of business risks

Again, we acknowledge that the Canadian authorities' guidance concerning minimum FMI liquid assets (i.e. capital) is preliminary and that final guidance will aim to ensure that a FMI has sufficient liquid assets to carry out its recovery and resolution plan. We support a broad definition of clearing agency capital, which acknowledges that these infrastructures perform bank-like activities and covers a full range of credit, liquidity, operational, and other risks.

Greater transparency into clearing agency risk methodologies may be required

At the international level, ISDA has called for clearing agencies to provide greater transparency regarding their methodologies and quantitative results when sizing loss absorbing resources, including initial margin, default funds and skin in the game. Consideration should be given to ISDA's recommendation. The CPMI-IOSCO public qualitative and quantitative disclosure frameworks, which are proposed as the basis for Canadian clearing agency disclosures, may fall short in this respect.

Specifically, the CPMI-IOSCO standards require that CCPs disclose exposure amounts associated with initial margin, default fund and liquidity stress testing, but not necessarily their underlying methodologies. Although public disclosure of stress-test methodologies may not be appropriate, we believe these enhanced disclosures could be offered directly to FMI participants.

In addition, ISDA has made calls for a regulatory-driven CCP stress testing regime, bringing comparability to the adequacy of CCPs' loss absorbing resources. We support the concept of CCP stress-tests and encourage further discussion on this topic. However, we also caution that regulatory stress scenarios should not become the de-facto standard for CCPs' own risk management. Regulators should continue to verify that a clearing agency covers specific risks related to the particular product classes they clear, with proper close-out period and liquidity assumptions.

Finally, regulation should support greater transparency regarding clearing agencies' credit due diligence process. Clearing agencies focus heavily on the market risk or loss given default analysis (i.e. ensuring they have enough collateral to close out); however, in our view, CCPs may not undertake a similar level of analysis on the probability of default of the membership. Greater transparency would serve as a starting point for regulators and participants to evaluate whether specific risks are also adequately covered by a CCP.

Guidance on CCP collateral must be supported by Provincial cash collateral regimes

Clearing agencies' collateral policies should favour assets with minimal credit, liquidity, and market risk, even in stressed market conditions; we support Canadian authorities' guidance to this effect.

However, despite this guidance, Canadian clearing agencies' direct and indirect participants may continue to face hurdles in posting and accepting the most liquid form of collateral – cash. As evidence of this constraint, certain Canadian clearing agencies continue to request alternative forms of collateral, such as letters of credit, to overcome uncertainty surrounding their ability to obtain a security interest in cash.

Although Quebec has made first steps towards facilitating the posting of cash collateral, we encourage other Canadian provinces to prioritize the implementation of legislative modifications that allow Canadian entities to offer a first priority security interest in cash to their counterparties.

Greater clarity could be provided regarding the Canadian regulatory process

The process for exempting foreign clearing agencies should be simpler

Access to foreign clearing agencies is critical to support Canadian banks' participation in a number of country-level derivatives and securities markets, as well as globally traded markets for over-the-counter derivatives and foreign exchange. For the benefit of foreign FMIs operating in the Canadian market – who are navigating an increasingly complex web of regulations and registration requirements across jurisdictions – we encourage Canadian regulators to simplify, to the extent possible, their process for obtaining an exemption from recognition.

Specifically, CSA members contemplate an exemption from recognition for foreign clearing agencies subject to a comparable regulation in their home jurisdiction; we believe that associated comparability determinations should be made at the jurisdiction-level, if possible. A requirement for each clearing agency to individually demonstrate how its home regime imposes similar requirements to CSA rules seems unnecessarily burdensome. If a foreign regime is deemed equivalent to Canadian requirements, all FMIs meeting such foreign requirements should be exempt.

Line by line comparisons of Canadian guidance against foreign clearing agency requirements should also be avoided. In certain areas, Canadian clearing agencies may be required to meet standards different than international minimums. Because of the significant risks Canadian entities face through Canadian infrastructures – due to the fact that the Canadian market is highly concentrated in terms of both FMIs and core participants – we see it as appropriate if local authorities apply more stringent requirements to the home market. However, foreign clearing agencies that meet the spirit of international standards should also be granted access to the Canadian market, particularly where there is no substitute clearing capabilities in Canada.

Finally, we encourage CSA members to provide clarity on their approach to application and coordination of the National Instrument. For example, if a foreign clearing agency is considered systemically important in one jurisdiction, thereby requiring recognition in Canada, it is not clear whether such a determination would cascade across CSA members. Similarly, if a clearing

agency is exempt from recognition in one province, it is also not clear whether this exemption would apply across others.

Greater detail of the enforcement approach to Canadian clearing agencies is needed

For Canadian clearing and settlement systems, several of which are designated for oversight by the Bank of Canada, while also being recognized and subject to regulation by one or more provincial authorities, the regulatory approach to enforcing applicable standards may not always be visible to its participants, leading to questions regarding diffusion of accountabilities.

We believe that a higher level of transparency could be brought to the Canadian regulatory process if the following elements were clarified through regulatory guidance:

- nominating a lead regulator for Canadian clearing agencies, with the Bank of Canada as lead for systemically important infrastructures;
- specifying the process, objectives, and outcomes of regulatory oversight as conducted by the Bank of Canada vs. regulation by provincial authorities; and,
- where Canadian clearing agencies perform self-assessments against national or international standards, requiring public or private audits of this compliance.

The end-objective should be the creation of an ecosystem where Canadian FMIs are pushed not only to meet the minimum international standards, but to design market-leading best practices. We remain open to alternative suggestions targeted towards these same objectives.

In closing, we thank CSA members and the Bank of Canada for the opportunity to provide comments on these important issues. Please do not hesitate to contact us to pose questions or further discuss points raised in this letter.

Sincerely,