ISDA and FIA Response to the Canadian Derivatives Clearing Corporation's Request for Comments n°: 066-24[1]

"Amendments to the default manual of the Canadian Derivatives Clearing Corporation regarding the corporation's default risk capital amount available during a default management process"

Executive summary

ISDA and FIA (together "the Associations") welcome the opportunity to provide comments on the proposed amendments to the default manual of the Canadian Derivatives Clearing Corporation (CDCC) regarding the corporation's default risk capital amount available during a default management process, which we will refer to as skin-in-the-game (SITG) thereafter.

The Associations welcome the CDCC's intention to increase its SITG "in the interest of promoting a strategic partnership with, and enhance the confidence of, Clearing Members".

However, we have a number of comments on the proposed approach, and would like to use this opportunity to stress the importance of appropriately sized SITG, in a manner that aligns the CCP's and its clearing members' incentives.

This response covers the positions of our members on the buy-side and sell-side. The paper does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views.

Detailed commentary

In the description of its proposed revised approach, CDCC notes that "SITG is not meant to be a material source of loss absorption capacity", and that "[i]t is meant to incentivize proper risk management and consequently should be sized consistent with the size of the business".

As we have set out in our **whitepaper on CCP Best Practices**[2], we agree that SITG is meant to align incentives of the CCP and its clearing members. However, for an effective incentivizing mechanism on the CCP's risk management, we suggested that a CCP should "expose a significant and dynamic part of its capital".

We welcome that **CDCC's proposed approach** would result in an increase of the amount of SITG compared to the current approach. However, the proposed nominal amount (at $15M) remains small in comparison to peers, based on the metrics provided by CDCC in the consultation. We also question the justification of the proposed size of SITG based on a percentage of the CCP's annual revenue. Because SITG is a subset of the CCP's own funds, it should at least be compared to the present value of a stream of future revenues rather than a flow of annual revenues. In any case, we would suggest putting forward a methodology that

[1] 066-24_en.pdf (cdcc.ca)
[2] assets.isda.org/media/b53b5127/55872319-pdf and https://www.fia.org/sites/default/files/2020-03/Central%20Clearing%20Recommendations%20for%20CCP%20Risk%20Management%20%28November%202018%29.pdf

justifies why the proposed size of SITG adequately aligns the CCP's and its clearing members' incentives. For this reason, comparisons between the proposed sizing of the layer of SITG with the size of the default fund would make more economic sense, and would be more informative to clearing members in terms of whether incentives on the CCPs are correctly set.

In addition, given CDCC is a **wholly owned subsidiary of the Montreal Exchange**, we would point to our suggested best practices for CCPs in a vertical silo, i.e. that "the exchange should be incentivized by providing parts of the SITG resources". We would welcome some consideration of this in CDCC's approach to sizing its SITG.

In addition, we would encourage CDCC to include provisions for a **second tranche of skin in the game**, positioned beneath member assessments in the default waterfall. Other jurisdictions, such as the EU and UK, include provisions for a second tranche of skin in the game in their regimes, and we consider that this approach should be implemented more widely.

We also question the proposed change with regards to **automatic replenishment**. Under the CDCC's current approach, the current SITG is described as "a 5+5 approach, where there is $5M currently at risk in the default waterfall with an additional $5M in pre-funded resources in place to automatically replenish the first layer if used". CDCC describes the proposed approach as resulting in a $5M increase over the current approach, to a SITG layer of $15M. However, it is unclear under the proposed approach whether and how CDCC would commit to replenish the SITG if it were to be used up.

We also note that the **proposed amendments to the Default Manual**, setting out that the layer of SITG "is determined by CDCC from time to time" leaves significant discretion to CDCC. We acknowledge that CDCC explains that "the amount of SITG should not be indicated in its Rules and Manuals but instead, be specified in CDCC Quantitative Disclosure documents posted on CDCC's website every quarter". However, with the proposed changes to the Default Manual, it is unclear how clearing members' views, as well as evolving circumstances, might be factored in by CDCC in subsequent discretionary revisions of its SITG. Therefore, we would suggest that CDCC includes in its Default Manual clear indications as to the guiding principles it would follow when resizing its layer of SITG, following a risk-sensitive and dynamic approach, ensuring alignment of incentives between the CCP and its clearing member. The governance around any subsequent changes to the size of the layer of SITG should also clearly be laid out in the rules. In particular, the rules should specify that the risk committee and/or advisory committees will be consulted ahead of any change.

Finally, while we appreciate that the language in the Default Manual refer to CDCC's resources "for the purposed of absorbing any loss outstanding after the exhaustion of the suspended Clearing Member's resources" – i.e. in default-loss scenarios – the consultation does not specify what CDCC's approach to exposing its SITG in NDLs scenarios is. Therefore, we would welcome clarifications as to CDCC's approach to using its SITG in **non-default loss scenarios**. In particular, we would note that if it intends to use its SITG for any NDL, it would have to immediately replenish these funds (although if the CCP is able to do so, it should have used such funds to cover the NDL instead). We also note that a NDL can happen together with a default loss, which should be factored into any plans for replenishing resources.

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